DUDLE[illegible] SCHOOL
NAVAL
MONTE[illegible]

NAVAL POSTGRADUATE SCHOOL
Monterey, California

THESIS

A MODEL FOR AN OPERATIONAL AUDIT
OF UNITED STATES COAST GUARD
NON-APPROPRIATED FUND ACTIVITIES

Paul Anthony Dufresne

September 1980

Thesis Advisor: R. A. Bobulinski

Approved for public release; distribution unlimited

T196284

UNCLASSIFIED

SECURITY CLASSIFICATION OF THIS PAGE (When Data Entered)

REPORT DOCUMENTATION PAGE		READ INSTRUCTIONS BEFORE COMPLETING FORM
1. REPORT NUMBER	2. GOVT ACCESSION NO.	3. RECIPIENT'S CATALOG NUMBER
4. TITLE (and Subtitle) A Model for an Operational Audit of United States Coast Guard Non-Appropriated Fund Activities		5. TYPE OF REPORT & PERIOD COVERED Master's Thesis: September 1980 6. PERFORMING ORG. REPORT NUMBER
7. AUTHOR(s) Paul Anthony Dufresne		8. CONTRACT OR GRANT NUMBER(s)
9. PERFORMING ORGANIZATION NAME AND ADDRESS Naval Postgraduate School Monterey, California 93940		10. PROGRAM ELEMENT, PROJECT, TASK AREA & WORK UNIT NUMBERS
11. CONTROLLING OFFICE NAME AND ADDRESS Naval Postgraduate School Monterey, California 93940		12. REPORT DATE September 1980 13. NUMBER OF PAGES 187
14. MONITORING AGENCY NAME & ADDRESS(if different from Controlling Office) Naval Postgraduate School Monterey, California 93940		15. SECURITY CLASS. (of this report) Unclassified 15a. DECLASSIFICATION/DOWNGRADING SCHEDULE

16. DISTRIBUTION STATEMENT (of this Report)

Approved for public release; distribution unlimited

17. DISTRIBUTION STATEMENT (of the abstract entered in Block 20, if different from Report)

18. SUPPLEMENTARY NOTES

19. KEY WORDS (Continue on reverse side if necessary and identify by block number)

operational audit, operational review, managerial audit, Coast Guard NAFA, auditing

20. ABSTRACT (Continue on reverse side if necessary and identify by block number)

Operational auditing is briefly described through an analysis of its development, nature, and the relationship between the author's qualifications and the purpose of an operational audit. Standards developed by the General Accounting Office for an operational audit are examined as a basis for comparison with current audit programs in Coast Guard Non-appropriated Fund Activities (NAFA). The need for an operational auditing program

DD FORM 1 JAN 73 1473 EDITION OF 1 NOV 65 IS OBSOLETE
S/N 0102-014-6601

(Page 1)

SECURITY CLASSIFICATION OF THIS PAGE (When Data Entered)

in Coast Guard NAFA is established based on the level of operations of large Coast Guard NAFAs. A model for an operational audit program in Coast Guard NAFA is developed along with proposed guidelines and considerations. Considerations in implementing the proposed operational audit program are discussed as well as the author's recommendations for implementing an operational audit program in Coast Guard NAFA. The author concludes that there is a need for an operational audit program in Coast Guard NAFA and that implementation of the developed operational audit model would improve the current Coast Guard NAFA internal audit program.

Approved for public release; distribution unlimited

A Model for an Operational Audit

of

United States Coast Guard Non-Appropriated Fund Activities

by

Paul Anthony Dufresne
Lieutenant, United States Coast Guard
B.S., United States Coast Guard Academy, 1974

Submitted in partial fulfillment of the
requirements for the degree of

MASTER OF SCIENCE IN MANAGEMENT

from the

NAVAL POSTGRADUATE SCHOOL
September, 1980

DUDLEY KNOX LIBRARY
NAVAL POSTGRADUATE SCHOOL
MONTEREY CALIF 93940

ABSTRACT

Operational auditing is briefly described through an analysis of its development, nature, and the relationship between the auditor's qualifications and the purpose of an operational audit. Standards developed by the General Accounting Office for an operational audit are examined as a basis for comparison with current audit programs in Coast Guard Non-appropriated Fund Activities (NAFA). The need for an operational auditing program in Coast Guard NAFA is established based on the level of operations of large Coast Guard NAFAs. A model for an operational audit program in Coast Guard NAFA is developed along with proposed guidelines and considerations. Considerations in implementing the proposed operational audit program are discussed as well as the author's recommendations for implementing an operational audit program in Coast Guard NAFA. The author concludes that there is a need for an operational audit program in Coast Guard NAFA and that implementation of the developed operational audit model would improve the current Coast Guard NAFA internal audit program.

TABLE OF CONTENTS

		Page
I.	INTRODUCTION	10
	A. GENERAL BACKGROUND	10
	B. OBJECTIVE OF THE STUDY	11
	C. METHODOLOGY	12
	D. THESIS ORGANIZATION	12
II.	OPERATIONAL AUDITING	14
	A. INTRODUCTION	14
	B. LEVELS OF AUDITING	15
	C. EVOLUTION OF OPERATIONAL AUDITING	16
	D. NATURE OF OPERATIONAL AUDITING	17
	E. AREAS OF RESPONSIBILITY	18
	F. AUDITOR'S IMPACT AND QUALIFICATIONS	20
	G. PREFERRED PRACTICES/MANAGEMENT CRITERIA	22
	H. INDEPENDENCE	23
	I. PROBLEMS	23
	J. GAO LEGISLATIVE HISTORY	25
	K. GAO STANDARDS	27
	1. General Standards	28
	2. Evaluation and Examination Standards	30
	3. Reporting Standards	31
	L. GAO EXAMPLES OF OPERATIONAL AUDITING	33
	M. SUMMARY	35

Page

III. OVERVIEW OF COAST GUARD NON-APPROPRIATED FUND ACTIVITIES (NAFA) REVIEW PROCEDURES 36

A. CURRENT GUIDELINES 36

B. FINANCIAL STATEMENTS 37

C. AUDIT EXAMPLES 41

1. USCG Support Center, Portsmouth, Virginia. 41

2. USCG Air Base, Elizabeth City, NC (CG Audit Team). 43

3. USCG Air Base, Elizabeth City, NC (DOT Audit Team) 45

D. SUMMARY. 46

IV. NEED FOR OPERATIONAL AUDITING. 47

A. GENERAL. 47

B. CURRENT LEVEL OF COAST GUARD NAFA. 47

C. INSPECTOR GENERALS ACT 53

1. Prior Developments 53

2. Provisions of the Act. 54

3. Effects of the Act 55

D. DOT REQUIREMENTS 56

E. MODEL FOR OPERATIONAL AUDITING 57

1. Defining the Objectives. 57

2. Survey and Planning Phase. 59

3. Review Phase 61

4. Reporting Phase. 62

F. SUMMARY. 62

Page

V. PROPOSED GUIDELINES. 64

A. GUIDELINES CONSIDERATIONS. 64

1. Flexible and Inflexible Guidelines 64

2. Potential Remedies 65

B. DEFINING THE OBJECTIVES. 66

C. SURVEY PHASE 67

D. REVIEW PHASE 69

1. General. 69

2. Procurement. 72

a. Determination of Need. 76

b. Authorization of Purchase. 77

c. Making of the Purchase 77

d. Follow-up on Purchase and Delivery . . 78

e. Payment Function 83

f. Auditor's Problems and Role. 83

3. Property Management. 84

a. Receipt and Control of Equipment and Supplies 85

b. Control of the Use of Facilities, Equipment, and Supplies. 86

c. Maintenance of Equipment and Facilities 86

d. Auditor's Role 87

4. Personnel. 92

a. Identification of Manpower Needs . . . 93

b. Recruiting and Hiring. 93

c. Training and Development 94

Page

d. Performance Appraisal and Promotion . . 95

e. Auditor's Role. 95

5. Fiscal Administration 96

a. Basic Financial Control 102

(1) Cash Control 102

(2) Accounts Payable 114

(3) Payroll. 115

(4) Auditor's Role 116

b. Financial Management. 116

(1) Current Operations 117

(2) Planning Role of Financial Management 119

E. REPORT. 120

1. GAO General Standards 121

2. Nature of the Audit 122

3. Scope 122

4. Findings/Results. 123

5. Recommendations 123

6. Comments. 124

7. Report Distribution 124

F. SUMMARY 124

VI. FIELD TEST OF THE MODEL 126

A. OPERATIONS AND ORGANIZATION OF THE U.S. COAST GUARD ACADEMY NAFA. 126

1. Level of Operations 126

2. Organization. 127

Page

B. APPLICATION OF THE MODEL. 128

1. Definition of Objectives. 128

2. Initial Survey. 129

3. Review Phase. 130

4. Report Phase. 132

C. SUMMARY 133

VII. IMPLEMENTATION 134

A. AUDITOR QUALIFICATIONS. 134

B. PLANNING. 137

C. MANUALS 140

D. AUDIT ORGANIZATION. 141

E. CONCLUSION. 142

APPENDIX A - Guidelines for Auditing Coast Guard Exchanges 144

APPENDIX B - USCG Support Center, Portsmouth, VA NAFA Audit Report 152

APPENDIX C - Elizabeth City Coast Guard NAFA Audit Board Report 161

APPENDIX D - USCG Air Base Elizabeth City NAFA DOT Audit Report 169

LIST OF REFERENCES 185

INITIAL DISTRIBUTION LIST. 187

I. INTRODUCTION

A. GENERAL BACKGROUND

> The focus of government auditing is changing. Auditing is no longer merely concerned with the appropriateness of financial records and compliance with legal requirements. Now the auditor is called upon to assess the economy, efficiency, and effectiveness of program operations. These additional responsibilities are not only new, they are also challenging. [Ref 1, cover letter]

Government agencies have always had the responsibility for establishing and maintaining adequate systems of internal control, [Ref 2, p 3-4] and for "carrying out operations efficiently, economically, and effectively." [Ref 2, p. 3-17] Economy refers to the operation of an organization from the least-cost point of view, while efficiency is concerned with "the relationship between benefits attained and costs incurred." [Ref 3, p. 18]

Through the use of both internal and external audit programs, agencies can assure themselves that their responsibilities are adequately met. With the impact of inflation on agency operations and the recent renewed interest of lawmakers in reducing inflation through the control of expenditures, the aforementioned revised focus of auditing on the economy and efficiency of agencies is especially important. This is the focal point of operational auditing.

Audits must be planned and managed so that they require a minimum of effort and attain the organizations' goals for the audit.

> A clear articulation of audit mission is essential because we are dealing with audit resources which will never be adequate to do all the things which we think we should do or that programs managers would like us to do. [Ref 4, p. 16]

The development of guidelines for an economy and efficiency, or operational audit, therefore becomes mandatory if agencies are to avail themselves of the tools of auditing and meet their responsibilities to their clientele and the public in general. Although the Coast Guard has developed guidelines for internal audits of various functions, these current efforts are directed primarily at a compliance type audit rather than an economy and efficiency type audit. With the increased attention being focused on operational auditing, there appears to be a need within the Coast Guard for this management tool.

B. OBJECTIVE OF THE STUDY

The objective of this study is to develop standards and guidelines for an operational audit to meet the need of one Coast Guard area, Non-appropriated Fund Activities (NAFA), and to discuss the implementation of the developed guidelines. Although aspects of an external audit are considered, the study is directed at an internal auditing function.

> Internal auditing is an independent appraisal activity within an organization for the review of operations as a service to management. It is a managerial control which functions by measuring and evaluating the effectiveness of other controls. [Ref 5, p. 3]

C. METHODOLOGY

Current Coast Guard internal audit procedures for NAFAs were analyzed to determine their applicability to an operational audit. Current Coast Guard NAFA audit efforts in general were reviewed and a library search was conducted for the purpose of comparing the Coast Guard's audit efforts to efforts in other segments of the public and private sectors. The need for a Coast Guard operational audit program was then assessed through the analysis of the level of current NAFA operations, of various agencies legal requirements and of the salient factors for an operational audit model. A model was then developed for operational auditing efforts to be implemented by the total Coast Guard in its NAFA operations. Potential guidelines for such an audit were developed based on guidelines established by the General Accounting Office, (GAO), along with an analysis of potential problems inherent in implementing such guidelines.

D. THESIS ORGANIZATION

Chapter II defines an operational audit. Its evolution as a particular type of audit is developed and the reasons for its evolution is also discussed. The nature of an operational audit is examined as well as how it differs from a financial compliance audit. Chapter III provides an overview of current Coast Guard NAFA internal audit procedures, reporting procedures, and describes the results from actual audits.

Chapter IV investigates the current level of operations of Coast Guard NAFAs as a prelude to establishing the need for an operational audit. A model of an operational audit for application at Coast Guard NAFA based on guidelines promulgated by the GAO for federal agencies is then presented. The model covers areas for potential operational audits and the general aspects of the survey, planning, and scope of an operational audit. Chapter V briefly discusses problems with establishing standards or guidelines such as inflexibility in the program or dysfunctional effects on managerial performance. Recommended guidelines based on the information presented in Chapter II and the model established in Chapter IV are then discussed. Chapter VI describes a brief field test of the model for the purpose of determining the feasibility of the developed model. Chapter VII deals with the author's recommendations for the implementation of a Coast Guard operational audit program for NAFA.

II. OPERATIONAL AUDITING

A. INTRODUCTION

This chapter defines the various aspects of an operational audit. Differences between an external operational audit and an internal operational audit are discussed. The responsibility of an auditor in relation to an operational audit is investigated. Efforts of the private sector in the area of operational auditing are also presented. Qualifications of auditors, such as education, experience, and mental attitude are examined. The organizational status of an internal auditing function is introduced. Problems that the private sector have experienced in implementing operational audit procedures are investigated as an insight to potential problems in implementing any operational audit program.

The next section discusses the efforts of the General Accounting Office (GAO) in developing operational audit procedures in the public sector. The legislative history of the GAO as it pertains to operational auditing is developed as a background for establishing the requirements for operational auditing. Audit standards of the GAO are also examined. Specific examples of the GAO's efforts in operational auditing are summarized as an indication of the potential benefits of operational auditing.

B. LEVELS OF AUDITING

There are different terms that have been used synonymously with operational auditing, such as operational review and management audit. An operational audit may be defined as:

> . . . a comprehensive and constructive examination of an organizational structure of a company, institution, or branch of government, or of any component thereof, such as a division or department, and its plans and objectives, its methods of control, its means of operation and its use of human and physical facilities. [Ref 6, p. 35]

It is the constructive nature of the operational audit that distinguishes it from the conventional audit which is concerned primarily with financial compliance. Since the operational audit's objective is to appraise and improve management performance and methods, it is more future-oriented while the conventional audit is concerned with the past.

In contrast to the private sector, the GAO has distinguished three levels of auditing in the public sector. Level I is concerned with the financial operations of an agency and the compliance of the agency with established laws. Level II is concerned with economy and efficiency, that is, whether the agency uses its resources in an efficient manner. Level III is concerned with whether the agency achieves the desired results of a particular program. It is the Level II audit of the GAO that most closely resembles the private sector's view of an operational audit. [Ref 3, p. 8]

Both public and private sectors view the operational audit as being an extension of a financial audit which

encompasses all aspects of an organization for the purpose of identifying ineffective operations with a view toward correcting them. [Ref 7, p. 484] It is thus directed at improving operations rather than just identifying improper procedures.

C. EVOLUTION OF OPERATIONAL AUDITING

The major impetus for internal operational auditing came from the organization itself. The desire to improve the performance of the organization led management to expand the internal auditing function. Because the internal auditor was already delegated the responsibility for the protection of the interests of the company, it was a natural extension of the internal auditor's responsibility into the operations of the company.

The major impetus for external operational auditing came from third parties who had an interest in the performance of management. These entities, such as stockholders and investment analysts, demanded an independent assurance that management was using its resources efficiently and effectively. The development of external operational auditing was also due to the desire of some organizations to have operational audit programs but who lacked the necessary resources to support an internal program.

A new need for the development of operational auditing has come from the rising awareness of the social responsibility

of organizations to use their resources economically and efficiently as a service to not only their stockholders but to society as well. While public sector organizations have always had a social responsibility, the concept of a social responsibility for private sector organizations is relatively new. [Ref 8, p. 41] The operational audit has therefore become not only a means for management to improve its operations but for concerned third parties and for society to assure themselves that management is doing a competent job. As the development of operational auditing continues, it is likely that it will be relied upon by various factions as an integral part of decision making.

D. NATURE OF OPERATIONAL AUDITING

While operational auditing is conceptually different from conventional auditing, its techniques are not. The techniques for an operational audit are similar to those for a conventional audit. An operational audit is characterized by the approach and the state of mind of the auditor, not by special programs or techniques. [Ref 9, p. 9] As of yet, there are no accounting profession auditing standards covering an operational audit as there are for financial audits. [Ref 1, p. 6] However, the GAO has established broad standards for Level II audits which cover examination and reporting performance standards. Even these GAO standards however, do not specify any particular techniques that are applicable only to

operational audits. The essence of an operational audit is in the manner of approach, analysis, and thought of the auditor and not in any rigidly defined procedures.

Although the techniques used in an operational audit may not significantly differ from those of a conventional audit, there are key differences between the two types of audits. The ultimate objective of a conventional audit is a report which contains the auditor's opinion. However, in an operational audit, such an opinion is not practical since the terms "efficiency" and "economy" are both relative, thus making an opinion as to whether or not an organization is either efficient or economical virtually impossible. Exhibit 2-1 provides a comparison between a conventional financial audit and an operational audit. While it is intended only as a summary, it does highlight the fundamental differences between the two types of audits.

E. AREAS OF RESPONSIBILITY

Some of the general areas of responsibility for an auditor in conducting an operational audit consist of the examination, appraisal, and recommendations of the organizations structure, the policies and procedures of the organization, and the records and reports of the organization. The GAO extends an auditor's responsibility to:

> . . . include inquiry into whether, in carrying out its responsibilities, the audited entity is giving due consideration to conserving its resources and using minimum effort to do its work. [Ref 1, p. 5]

EXHIBIT 2-1

CONVENTIONAL VS. OPERATIONAL AUDITING*

CHARACTERISTIC	CONVENTIONAL	OPERATIONAL
1. Purpose	express an opinion on financial condition and on stewardship	appraise and improve management methods and performance
2. Scope	the fiscal record	interrelated business functions
3. Method	emphasis on accounting skills	emphasis on inter-disciplinary skills
4. Time-orientation	to the past	to the future
5. Precision	absolute	relative
6. Recipients	external-stockholders government, public	internal-management
7. Realization	actual	potential
8. Necessity	legally required	optional
9. Practice	archaic	recent
10. Catalyst	tradition	executive intuition

*J. W. Buckley, "Operational Audits by Public Accountants," Abacus, Vol. 2, No. 2, (December 1966), p. 159-171

This responsibility varies from that of a financial audit in that the auditor is dealing with the entire organization as a whole rather than just with its individual parts. The operational auditor must deal with the system, the process, and the interrelation between the parts, not just with the individual entitities.

F. AUDITOR'S IMPACT AND QUALIFICATIONS

A key factor in the success of any operational auditing program is the acceptance and implementation of any recommendations of the auditor. This acceptance often depends on the respect of management for the knowledge and ability of the auditor's staff.

Since the operational audit in the private sector evolved from the internal control function, the qualifications for conducting either of the two functions are similar. While there are no specific qualifications required for either audit, there are certain practical educational, experience, and other qualifications that an auditor should possess.

The operational auditor must have an in-depth knowledge of such subjects as accounting, data processing, statistics, and basic business administration. An education covering these fields provides the auditor with the basic tools of auditing. It is also important that the auditor have a grounding in the humanities and the behavioral sciences [Ref 10, p. 25] since the auditor will have to deal with

people as well as with numbers and accounts. Qualifications based on experience are even harder to define. While there are no recommended requirements, the auditor still must be able to communicate recommendations to operating personnel and identify areas where problems exist. In this respect, practical experience can add credence to any recommendations.

Various other less tangible characteristics have also been mentioned as auditor qualifications. [Ref 9, p. 20] A key trait commonly mentioned is one of curiosity. The auditor must be interested in the achievements and the problems of line personnel, and must be inquisitive as to the reasons for various actions. The auditor must also be persistent in evaluating a situation until a thorough knowledge or satisfaction is obtained that a situation is actually as perceived. As previously mentioned, the auditor must also have a constructive approach to a situation. The auditor must be concerned with improving a situation and not with determining responsiblity. The auditor must view mistakes as keys to future improvement. The auditor should also have a business sense, that is, a broad perspective of the whole business and not just of a particular area.

> He is not governed by dogmatic ideas as to what is "right" or "wrong". Each situation is separately appraised on its own merits. When evaluating any particular area, he keeps in mind the relationship of that operation with others and with the business as a whole. [Ref 9, p. 20]

A final trait is one of cooperation with those being audited.

G. PREFERRED PRACTICES/MANAGEMENT CRITERIA

The auditor should be concerned with improving, not criticizing, operations. The auditor's purpose is more to insure that recommendations are implemented rather than in receiving credit for recommendations. While conventional auditors have traditionally had an accounting background, it is interesting to note that from 24 percent to 26 percent of the professional staffs for operational auditing consist of non-accountants. [Ref 7, p. 487] Because operational auditing is concerned with the interrelated aspects of an organization, it does not limit itself to any one area during an audit. This has hindered the development of specific programs for operational audits. However, audit programs for operational audits have relied on the development of management criteria as frameworks for programs.

The concept of management criteria is similar to that of a "preferred practice". The planning of operational audits is based on the concept that good management contains common denominators that are relevant to all types of business organizations. The operational audit program thus begins with the identification of these key managerial elements. Identifying these elements requires either a horizontal approach, which recognizes key elements applicable to management objectives or a vertical approach which recognizes key elements applicable to particular functions. The selection of management criteria allows the comparison of one department with another or the same department with itself over time.

An operational audit thus begins with the identification of various procedures or policies that have been generally significant in improving the quality of managerial control. Some authors even recommend the assignment of relative quality points based on the presence or absence of established management criteria. A key problem in the field of operational auditing, however, is the development of these management criteria. [Ref 7, p. 489]

H. INDEPENDENCE

A key factor affecting the success of any audit is the independence of the auditor. Because independence is closely related to the organizational status of the internal auditor, the Institute of Internal Auditors has described the organizational position of the auditor as follows:

> The organizational status of the internal auditor and the support accorded to him by management are major determinants of the range and value of the services which management will obtain from the internal auditing function. The head of the internal auditing department, therefore, should be responsible to an officer of sufficient rank in the organization as will assure a broad scope of activities, and adequate consideration of an effective action on the findings or recommendations made by him. [Ref 9, p. 36]

It is important therefore for the auditor to be in a position to deal with operating managers as an equal to insure an effective functioning of the audit process.

I. PROBLEMS

While the operational audit evolved in the private sector, this sector also has experienced the most problems in

implementing effective operational audit programs, especially external audits. [Ref 11, p. 519] While internal audits made for management and requested by management, pose few serious problems of independence for the internal auditor, the independence of external auditors in an operational audit does. While common and statutory law has established the necessity of independence of external auditors in a conventional audit, no such protection exists in the operational audit. There is no assurance for third parties therefore, that the appropriate degree of independence and objectivity exists.

Another problem yet to be resolved concerns the format for the audit report. [Ref 11, p. 520] Because it is difficult for an auditor to express an opinion regarding such a relative item as performance, as previously mentioned, it is unlikely that a standardized report such as the one used for independent attestations will be developed.

Another aspect that is a potential problem is in the verification of data. Traditional auditing techniques are based on accounting data and verification procedures have been developed for handling such evidence. The verification of non-accounting data will require the development of competence in other fields and of other appropriate verification procedures.

A final problem is related to the competence of auditors to analyze performance and make appropriate recommendations. The ability to conduct such an audit assumes competence in

several fields and an in-depth knowledge of the organization. Whether internal auditors or external auditors have this competence or can even achieve this competence has been questioned. [Ref 11, p. 522-523]

J. GAO LEGISLATIVE HISTORY

The Budget and Accounting Act of 1921 established the GAO for the primary purpose of providing an independent evaluation of executive expenditures. [Ref 2, p. 3-2] Since its inception the GAO's powers have been considerably broadened through various legislation.

The Government Corporation Control Act of 1945 was designed to bring Government Corporations under the control of the GAO. The Act specifically authorized the GAO to audit wholly owned government corporations "in accordance with the principles and procedures applicable to commercial corporate transactions." [Ref 2, p. 3-3]

The Legislative Reorganization Act of 1946 extended the duties of the Comptroller General, who is the head of the GAO, to encompass even broader audit authorization.

> Section 206. "The Comptroller General is authorized and directed to make an expenditure analysis of each agency in the executive branch of the Government (including Government corporations), which, in the opinion of the Comptroller General, will enable Congress to determine whether public funds have been economically and efficiently administered and expended." [Ref 2, p. 3-4]

The Federal Property and Administrative Services Act of 1949 directed the GAO to make audits of property accounts.

> Such audit shall be conducted. . .and shall include but not necessarily be limited to an evaluation of the effectiveness of internal controls and audits, and a general audit of the discharge of accountability for Government-owned or controlled property based upon generally accepted principles of auditing. [Ref 2, p. 3-5]

The Accounting and Auditing Act of 1950 led to the development of the first two levels of auditing established by the GAO.

> The auditing for the Government. . . (will) be directed at determining the extent to which accounting and related financial reporting fulfill the purposes specified, financial transactions have been consummated in accordance with laws, regulations or other legal requirements, and adequate internal financial control over operations is exercised, and afford an effective basis for the settlement of accounts and accountable officers. [Ref 2, p. 3-5]

Section 117(a) of the Act specified audit procedures to be as follows:

> In the determination of auditing procedures to be followed and the extent of examination of vouchers and other documents, the Comptroller General shall give due regard to generally accepted principles of auditing, including consideration of the effectiveness of accounting organizations and systems internal audit and control, and related administrative practices of the respective agencies. [Ref 2, p. 3-6]

The Legislative Reorganization Act of 1970 established the third level of audits in the GAO:

> The Comptroller General shall review and evaluate the results of Government programs and activities carried on under existing law when ordered by either House of Congress or upon his own initiative. . . [Ref 2, p. 3-7]
>
> (c) The Comptroller General shall develop and recommend to the Congress methods for review and evaluation of Government programs and activities carried on under existing law. [Ref 2, p. 3-7]

The General Accounting Act of 1974 is of special interest to this study since it established authority for the GAO to audit non-appropriated fund activities.

> (a) the (1) operations and funds of non-appropriated fund and related activities. . .such. . .Coast Guard Exchanges. . .(2) systems of accounting and internal controls of such funds and activities, and (3) any internal or independent auditor or review of such funds and activities shall. . .be subject to review by the Comptroller General of the United States in accordance with such principles and procedures and under such rules and regulations as he may prescribe. [Ref 2, p. 3-9, 3-10]

While the GAO has the statutory authority to audit agencies, it is important to note that any recommendations developed as a result of any audit, are not required to be implemented by the agency. However, these recommendations are reported to Congress if they require any Congressional enactment or review. In response to this statutory authority, the GAO has developed guidelines for agencies in developing audit standards for the three levels of auditing established by the GAO.

K. GAO STANDARDS

While the responsiblity for internal audit policy was transferred from the GAO to the Office of Management and Budget in 1975, [Ref 2, p. 3-43] the standards for audits established by the GAO in 1973, [Ref 2, p. 3-43] are still the norm upon which public sector audits are based. The standards are classified according to three categories: general, examination

and evaluation, and reporting. The standards closely parallel those established by the American Institute of Certified Public Accountants (AICPA), and are summarized in Exhibit 2-2.

1. General Standards

The first general standard is concerned with the scope of an audit. In determining the scope of an audit, the GAO considers the concept of a single audit, one encompassing all three levels of auditing, to be desirable. The three levels require:

a. an examination of financial transactions, accounts, and reports, including an evaluation of compliance with applicable laws and regulations.

b. a review of efficiency and economy in the use of resources.

c. a review to determine whether desired results are effectively achieved. [Ref 2, p. 3-65]

The GAO also considers the needs of the users to be a determining factor in establishing the scope of an audit. [Ref 2, p. 3-65]

The second general standard deals with auditor qualifications.

> The auditors assigned to perform the audit must collectively possess adequate professional proficiency for the tasks required. [Ref 2, p. 3-65]

While this standard is broad in that it mandates only professional proficiency for the tasks required, [Ref 2, p. 3-65] it recognizes a key factor by determining auditor competency in terms of the collective audit team. The standard recognizes that few auditors have the expertise to adequately handle all possible

EXHIBIT 2-2

AUDITING THEORY INTERRELATIONSHIPS*

CONCEPTS	POSTULATES	AUDITING STANDARDS (AICPA, GAO)
1. Ethical conduct	1. Potential conflicts of interest	Proficiency as an auditor (AICPA, GAO)
2. Independence	2. Exclusively an auditor	Independent attitude (AICPA, GAO)
3. Due audit care	3. Professional obligation	Due professional care (AICPA, GAO) Scope of audit (GAO) Needs of users (GAO)
4. Evidence	4. Verifiability 5. Internal control and reliability 6. Past holds true for the future	Planning and supervision (AICPA, GAO) Study and evaluation of internal control (AICPA, GAO) Sufficient, competent evidential matter (AICPA, GAO) Compliance review (GAO)
5. Fair presentation	7. Application of generally accepted accounting principles results in fair presentation	Generally accepted accounting principles (AICPA, GAO) Other specified accounting principles (GAO) Consistency (AICPA,GAO) Adequate informative disclosures (AICPA,GAO) Compliance violations (GAO) Expression of opinion or a disclaimer (AICPA, GAO) Distribution and timing (GAO) Detail report content (GAO)

*J. C. Robertson, AUDITING, Dallas, TX: Business Publications, Inc., 1979, p. 45

matters and thus advocates the value of an audit team which collectively possesses the necessary expertise.

The third standard relates to auditor independence. It requires both the auditor and the audit organization to be independent "in all matters relating to the audit work". [Ref 2, p. 3-66]

The fourth and final general standard requires the auditor to exercise "due professional care" while conducting the audit and in preparing reports. [Ref 12, p. 29] This standard is related to the second and third general standard of independence and professional competence in that it requires the auditor to possess the necessary qualifications for the auditing profession and that they be exercised in a proper manner during the audit.

2. Evaluation and Examination Standards

The first evaluation and examination standard simply specifies that all work is to be adequately planned. The second standard relates to the general standard of due professional care in that it requires the proper supervision of the auditors and essentially complements the standard of auditor competence by requiring an auditors work to be checked by other competent personnel. The third standard is related to the first level of auditing in the GAO in that it requires a review of the agencies compliance "with legal and regulatory requirements". [Ref 2, p. 3-66] The fourth standard requires

the auditor to review the internal control procedures of an agency to assess the extent that they can be relied upon "to ensure accurate information, to ensure compliance with laws and regulations, and to provide for efficient and effective operations." [Ref 12, p. 39] The final standard relates to the concept of evidence.

> Sufficient, competent, and relevant evidence is to be obtained to afford a reasonable basis for the auditor's opinions, judgments, conclusions, and recommendations. [Ref 2, p. 3-66]

3. Reporting Standards

Reporting standards for the GAO concern submission of the audit report, the timeliness of the report, and general standards as to the content and format of the report.

The first standard requires that the audit reports be submitted to the appropriate official of the agency who is responsible for taking action on any audit findings or recommendations "and to others responsible or authorized to receive such reports. [Ref 2, p. 3-66] The second standard concerns the submission of the audit report in a timely manner. The GAO defines "timely" as being:

> . . . on or before the date specified by law, regulation, or other arrangement, and, in any event, as promptly as possible. . . [Ref 2, p. 3-66]

The third standard comprises subjective concepts applicable to most audit reports. These standards specify that audit reports should be concise yet clear and complete enough for a proper understanding by its users. Reports should "present

matter accurately, completely, and fairly." [Ref 2, p. 3-66] The language of the report should present findings in an objective and clear manner and only that information that is adequately supported by evidence should be included in the report. The auditors recommendations for improvements and any information on the underlying causes of any problems should also be included.

Because of the desired nature of the audit, the report should be constructive in its tone rather than critical of past actions, and should include any areas or issues requiring further study. In keeping with the constructive nature of the audit, any accomplishments of the agency should be included, especially where such procedures might be applicable to other areas in the agency.

The audit report should indicate the views of the responsible officials in the agency or activity audited as to the appropriateness of the auditor's finding and recommendations. It should explain the scope of the audit and its objectives and whether or not any significant information was withheld from the report because it was deemed privileged or confidential. The nature of such information should be fully described as far as practical and the reason for its withholding explained.

The fourth and final reporting standard specifies that each report should contain the auditors opinion as to the degree that financial reports are fairly presented and any

other supplementary information about the reports that may be considered necessary for full and informative disclosure.

L. GAO EXAMPLES OF OPERATIONAL AUDITING

In an audit of the Federal Employees Group Life Insurance Program, [Ref 13, p. 87-92] the clientele, who were active and retired employees of the Government, were concerned with the relatively high premiums and low coverage provided by the program. The GAO audited the program by conducting an extensive literature search and gathered authoritative views on the benefits and lack of benefits for an organization acting as its own insurer. This study led to the development of nine different methods for improving the program at no additional cost. By questioning why the program was ineffective, the GAO had determined that the premiums were higher because the Government had chosen a different way to fund anticipated benefit payments from that used in the private sector. By studying the private sector, the GAO was able to recommend a new way of funding which was later approved by Congress. This example is illustrative in that it shows that the GAO expanded the audit to include why the service of the program was defective, and did not limit the audit to merely a compliance review. A conventional audit normally would not have included an investigation into the practices of private sector insurance companies.

In an audit of the Post Office, the GAO recommended that certain rural Post Offices be closed as an economy measure. [Ref 13, p. 93-100] When confronted with protests from the Post Office that such closing would be opposed because of the resulting poorer service, the GAO conducted a survey of those areas where closings had already occured and discovered that, contrary to the Post Office's belief that poorer service resulted from the closings, the affected areas reported an improvement in service. This case represents the constructive attitude of the auditor necessary in an operational audit. The GAO was concerned with why the Post Office was experiencing huge deficits and in remedying the situation rather than in establishing the responsibility for the situation.

In these and other studies, operational audits have produced intangible benefits. [Ref 14, p. 7] One benefit was that the auditors themselves became more aware of the constructive stimulations of those who were directly concerned with the program in question. Another intangible benefit was the educational impact of the operational audit on employees and officials and their development of a greater respect for management. Thus the operational audit process itself can produce benefits to both the organizations' personnel and the audit organization as well.

M. SUMMARY

This chapter has defined an operational audit and described the efforts of organizations in both the public and private sectors. Standards for auditing were also discussed.

The next chapter describes the current guidelines for an internal audit of Coast Guard Non-appropriated Fund Activity, (NAFA), the basic reports required of Coast Guard NAFA, and three actual audit reports from two Coast Guard NAFAs.

III. OVERVIEW OF COAST GUARD NON-APPROPRIATED FUND ACTIVITIES (NAFA) REVIEW PROCEDURES

A. CURRENT GUIDELINES

Current guidelines for auditing Coast Guard NAFA are found in Appendix F to the Manual for Non-appropriated Fund Activities, (CG-146). The guidelines provide audit board members with specific procedures and instructions for conducting audits of Coast Guard NAFA's and are in Appendix A. CG-146 requires that the audits be done on at least a quarterly basis and that the audit board be comprised of at least two officers, of which one must have had some experience or training in fiscal matters. [Ref 15, par A2012]

The guidelines outline four aspects of audit board members' responsibility:

1. familiarization with applicable guidelines and instructions.
2. the testing of the validity of accounting transactions and of the accuracy of accounting records.
3. evaluating the effectiveness of internal controls, and
4. the preparation of a report to the commanding officer of the unit outlining the financial condition of the exchange and suggesting improvements in operating procedures.

The guidelines also contain instructions for the preparation of working papers. These instructions are consistent with those developed by the General Accounting Office (GAO) and contain specific requirements concerning the format and content of working papers.

A major portion of the guidelines contain detailed procedures for various audit programs. The programs are directed at a financial compliance type audit rather than one specifically directed at improving operations. The audit programs cover the following sections: cash on hand, petty cash fund, cash in bank, investments, other assets, net worth, observation of inventory taking, accounts receivable, exchange property records, accounts payable and other liabilities, sales, purchases and expenses, taxes, and other areas.

The programs describe specific tracing, vouching, and confirmation procedures to be followed during the audit. Vouching is the examination of documents backward from the accounts through the bookkeeping filing system to find the source documents that support the item selected. It provides evidence that all recorded data are properly supported by source documents. Tracing is the examination of documents forward from the source documents through the bookkeeping filing system to its recording in the accounting system. It provides evidence that all events are recorded. Confirmation is the procedure of verifying the existence and accuracy of accounts or assets with outside independent parties.

B. FINANCIAL STATEMENTS

There are two basic financial statements prepared by the activities: the Results of Operations Report, (ROR) and the Statement of Financial Condition, (SFC).

The ROR is similar to a basic income statement in the private sector and is enclosed in Exhibit 3-1. The report shows the operating profit for each entity of the NAFA. Entities are the various stores, such as the barbershop, main store, etc., that make up the NAFA. Operating profit is gross sales less cost of goods sold, personnel expenses, and any other direct expenses. Interest income and other income, general and administrative expenses, and miscellaneous expenses are reported leading to the computation of the net profit for the entire activity. The report also indicates the distribution of profits, the amount of surveys or markdowns, and the amount of capital expenditures.

The SFC is similar to a basic balance sheet in the private sector and is enclosed in Exhibit 3-2. It shows current assets, which includes various cash accounts, accounts receivable, merchandise, adjusted for shrinkage, prepaid expenses and other miscellaneous current assets. Fixed assets are also shown according to the major classifications. Current liabilities and long term liabilities are shown and a resulting net worth figure computed. The report also requires the aging of accounts receivable and accounts payable.

The current audit program previously mentioned is concerned primarily with the verification of the accounts presented in these two statements. The two statements provide a quick summary of the extent of the activities operations and could potentially be used to determine trends in operating profit and net worth.

U. S. COAST GUARD NON-APPROPRIATED FUND ACTIVITIES
RESULTS OF OPERATIONS - REPORT I.D. (1-2) A1

INITIAL ____
REVISED ____

DISTRICT _____ UNIT NAME _____ YEAR/QUARTER Y R Q UNIT NUMBER (3-6) U

ACTIVITY IDENTIFICATION: (USE CODE)	ACTIVITY NAME 7- 8	— —	— —	— —	— —	— —	— —	— —	GRAND/PAGE TOTAL Z Z
1. SALES	9-16								
2. BEGINNING INV. (LINE 4 LAST RPT.)	17-24								
3. PURCHASES	25-32								
4. LESS: END INV. (ACTUAL)	33-40								
5. TOTAL: COST OF GOODS (2+3-4)	41-48								
6. GROSS PROFIT (1-5)	49-56								
7. PERSONNEL COST	57-64								
8. OTHER DIR. EXP.	65-72								
9. OPERATING PROFIT (6-(7+8))	73-80								
10. INTEREST INCOME *	9-16	//////	//////	//////	//////	//////	//////	//////	
11. INCOME - DISCOUNTS TAKEN	17-24	//////	//////	//////	//////	//////	//////	//////	
12. OTHER INCOME	25-32	//////	//////	//////	//////	//////	//////	//////	
13. GEN. & ADMIN. EXPENSES:									
14. GEN. & ADMIN. PERSONNEL	33-40								
15. PROVISION FOR ASSET REPLACEMENT	41-48								
16. OTHER GEN. & ADMIN.	49-56								
17. TOTAL (14+15+16)	57-64								
18. SYSTEM EXPENSES:									
19. HQ NAFA O/H	65-72								
20. SATELLITE PAYMENTS	73-80								
21. OTHER **	9-16								
22. TOTAL (19+20+21)	17-24								
23. NET PROFIT(9 thru 12)-(17+22)	25-32								
24. PROFIT DISTRIBUTION:									
25. RETAINED - 35%	33-40								
26. CG TRUST FUND	41-48								
27. DISTRICT REMITTANCE	49-56								
28. UNIT MORALE	57-64	//////	//////	//////	//////	//////	//////	//////	
29. EXCESS RTND. [illegible]	65-72	//////	//////	//////	//////	//////	//////	//////	
30. SURVEYS MARKDOWNS (MEMO)	73-80								
31. SATELLITE SALES (MEMO) ***	9-16								
32. PROPERTY CAPITAL EXPEND (MEMO)	17-24								

FOR DISTRICT OFFICE REPORTING USE ONLY

1. District Fixed Asset Replacement Reserve
   a. Increase: Unit Funds Received _____
   b. Decrease: Disbursements to unit _____
2. Unit District Remittances
   a. Amounts received _____
   b. Amounts Disbursed _____
      (1) District Overhead Exp (LN 23) _____
      (2) Unit Morale (LN 28) _____
      (3) District Morale _____
      (4) Addtl Alloc to Fixed Asset Res _____
      (5) Retained/other (indicate) _____
      (6) Expenditure of PRIOR Earnings _____

*COLUMNS 1-3 KEYPUNCH "A2" UNIT NO."U _ _ _ " ACTIVITY ID "_ _" **COLUMNS 1-8 KEYPUNCH "A3" UNIT NO "U _ _ _ " ACTIVITY ID "_ _"

***COLUMNS 1-8 KEYPUNCH "A4" UNIT NO. "U _ _ _ " ACTIVITY ID "_ _"

DEPT. OF TRANSP., USCG, CG-[illegible] (TEST)

U. S. COAST GUARD NON-APPROPRIATED FUND ACTIVITIES
STATEMENT OF FINANCIAL CONDITION - UNIT/DISTRICT, REPORT (I-2) B I

INITIAL ___
REVISED ___

UNIT NAME _____ DISTRICT NUMBER ___ ___ YEAR QUARTER Y R ___ ___ Q ___ UNIT NO. (3-6) U ___ ___ ___ ___

ASSETS

		COLUMN REFERENCE	
1.	CURRENT ASSETS		
2.	CASH		
3.	AUTHORIZED CASH FUNDS	7-14*	
4.	UNDEPOSITED CASH (DNJ (COL. I-2)-line 3)	15-22	
5.	CHECKING ACCOUNTS (DNJ COL. 3-4)	23-30	
6.	SAVINGS ACCOUNT BALANCE (PASSBOOK)	31-38	
7.	CERTIFICATES/SECURITIES (DNJ COL. 28-29)	39-46	
8.	TOTAL CASH (LINES 3+4+5+6+7)	47-54	
9.	OTHER CURRENT ASSETS		
10.	ACCOUNT RECEIVABLES 1/ (DNJ A/R COL 28-29)	55-62	
11.	INVESTMENT IN SATELLITE (INV. AT RETAIL)	63-70	
12.	MERCHANDISE INVENTORY (ACTUAL ENDING)	71-78	
13.	*LESS: SHRINKAGE ALLOWANCE **	7-14	
14.	*PREPAID EXPENSES	15-22	
15.	*OTHER (SPECIFY)	23-30	
16.	TOTAL OTHER CURRENT ASSETS (LINES 10 TO 15)	31-38	
17.			
18.	TOTAL CURRENT ASSETS (LINES (9+16)	39-46	
19.			
20.	FIXED ASSETS		
21.	*EQUIPMENT	47-54	
22.	*FURNITURE & FIXTURES	55-62	
23.	*VEHICLES	63-70	
24.	*OTHER (SPECIFY)	71-78	
25.	*LESS: ACCUM. DEPRECIATION ***	7-14	
26.	TOTAL FIXED ASSETS (LINES 21+22+23+24-25)	15-22	
27.			
28.	OTHER NONCURRENT ASSETS (SPECIFY)	23-30	
29.	TOTAL ASSETS (LINES 18+26+28) (MUST EQUAL		
30.	TOTAL LIABILITIES AND NET WORTH)	31-38	
31.			

LIABILITIES

		COLUMN REFERENCE	
	CURRENT LIABILITIES		1.
	ACCOUNTS PAYABLE		2.
	VENDOR 2/ (TRADE) (DNJ COL. 13-12)	39-46	3.
	GOVERNMENT 2/ (DNJ COL. 13-12)	44-54	4.
	ACCRUED LIABILITIES (DNJ COL. 13-12)	55-62	5.
	REMITTANCES (DNJ COL. 13-12)	63-70	6.
	LOANS (DNJ COL. 29-28)	71-78	7.
	OTHER (DNJ COL. 13-12) #	7-14	8.
	TOTAL CURRENT LIABILITIES (LINES 3 TO 8)	15-22	9.
	LONG TERM LIABILITIES		10.
	TRUST FUND LOANS (DNJ COL. 29-28)	23-30	11.
	COMMERCIAL LOANS (DNJ COL. 29-28)	31-38	12.
	*OTNER (SPECIFY)	39-46	13.
	TOTAL LONG TERM LIAB. (LINES 11+12+13)	47-54	14.
			15.
	TOTAL LIABILITIES (LINES 9+14)	55-62	16.
			17.
	NET WORTH		18.
			19.
	NET WORTH-BEG. UNRES.(LN. 22, PRIOR REPT.)	63-70	20.
	-CURRENT (LINE 25+29, PRS REPT.)	71-78	21.
	TOTAL UNRES. NET WORTH (LINE 20+21) ##	7-14	22.
			23.
	*NET WORTH RES: CAPITALIZ. OF NAFA ASSETS	15-22	24.
	ASSETS ACQUIRED WITH APPROP. FUNDS	23-30	25.
	RESERVE FOR REPLCMNT. OF FIXED ASSETS	31-38	26.
	TOTAL RES. NET WORTH (LINES 24+25+26)	39-46	27.
			28.
	TOTAL NET WORTH (LINES 22+27)	47-54	29.
			30.
	TOTAL LIAB. AND NET WORTH (LINES 16+29)	55-62	31.

1/ ACCOUNTS RECEIVABLE AGING:
INDICATE THE BREAKDOWN OF ACCOUNTS RECEIVABLE:

AGE	COLUMN	AMOUNT
0-60 DAYS ###	7-14	
61-90 DAYS	15-22	
OVER 91 DAYS	23-30	
TOTAL (LINE 10 ABOVE)	31-38	

2/ ACCOUNTS PAYABLE, VENDORS PLUS GOVERNMENT, AGING:
INDICATE THE BREAKDOWN OF ACCOUNTS PAYABLE:

AGE	COLUMN	AMOUNT
0-60 DAYS	39-46	
61-90 DAYS	47-54	
OVER 91 DAYS	55-62	
TOTAL (LINES 3 & 4 ABOVE)	63-70	

PREPARED BY _____ DATE _____

REVIEWED BY _____ DATE _____

* DENOTES ENTRIES GENERALLY NOT APPLICABLE TO SMALL NAFA.
** COLUMNS 1-6 KEYPUNCH "B 2" UNIT NO. "U ___ ___"
***COLUMNS 1-6 KEYPUNCH "B 3" UNIT NO. "U ___ ___"
COLUMNS 1-6 KEYPUNCH "B 4" UNIT NO. "U ___ ___"
COLUMNS 1-6 KEYPUNCH "B 5" UNIT NO. "U ___ ___"
COLUMNS 1-6 KEYPUNCH "B 6" UNIT NO. "U ___ ___"

DEPT. of TRANSP., PSCC, CG-5228A (TEST)

Exhibit 3-2

C. AUDIT EXAMPLES

This section is concerned with three actual audit reports from two activities. The stated and inferred objectives of the audits, the actual findings of the audits, and any recommendations from the auditors are examined for the purpose of determining to what extent current audits are dealing with any problems discovered during the audit. The analysis is not meant to criticize the auditors or their efforts but to provide an indication of the current level of audit operations in Coast Guard NAFAs. The audit reports are from the activities at the U.S. Coast Guard Support Center in Portsmouth, Virginia, and the U.S. Coast Guard Air Base at Elizabeth City, North Carolina. Two reports are analyzed from the Elizabeth City activity, one by a Coast Guard audit team and one by personnel from the Department of Transportation (DOT) regional office in Atlanta, Georgia.

1. USCG Support Center, Portsmouth, Virginia

This report is for the period which ended on January 31, 1978 and is enclosed in Appendix B. No objectives for the audit were stated in the report. The audit was done in accordance with CG-146, the Manual for Non-appropriated Fund Activities. From the nature of the findings and recommendations, it can be inferred that the audit was primarily a financial compliance type audit.

The findings and related recommendations of the audit were concerned with cash management, inventory, purchases and expenses, stock layout, and other items relating to internal control. The format of the report was organized along the various program lines, such as cash management, inventory, etc.

The findings in the cash management section of the report dealt with the timeliness of bank deposits and indicated that deposits were being properly made but not in a timely manner. The report does not indicate the length of the delays in depositing the funds and no criteria defining "timely" is given.

In the Inventory section, the audit team noted that the warehouse for the activity was poorly organized but did not indicate the consequences, actual or potential, of the deficiency. No criteria for this determination was indicated. However, the audit team did recommend an organization plan for the warehouse and also recommended an internal control procedure for improving the accountability of warehouse material.

The Purchases and Expenses section indicated internal control problems relating primarily to the lack of proper accounting procedures. The audit teams' recommendations were of a general nature and dealt with improving the accounting procedures of the activity.

The audit teams' appraisal of the activities stock layout is an exception to the financial compliance nature of the audit. The audit team commented on the crowded layout of the activity, especially in the clothing section. Although their recommendation was for the NAFA officer to only study the problem, their observation of such a problem is related to the constructive or improvement oriented nature of an operational audit.

The final area covered by the audit team was concerned with various aspects of internal control such as security and the separation of duties of various personnel. While some of the recommendations concerned the improvement of operations, most of the findings and reocmmendations dealt with problems in internal control.

Throughout the entire report, no specific criteria for findings was mentioned, no analysis of the consequences of problems was presented, and the auditors opinions were not separated from their findings. In addition, the report did not contain any responses from the auditee.

2. USCG Air Base, Elizabeth City, NC (CG Audit Team)

This report is for the period which ended on January 31, 1978 and is enclosed in Appendix C. There were no stated objectives for the audit listed in the report, only that it was done in accordance with CG-146. The report does mention that the audit team emphasized operational practices. However, the findings and recommendations contained in the report imply

that the audit was primarily directed at compliance with rules and regulations and at internal control problems.

In their opening general comments the audit team mentions that one of their recommendations from a previous audit concerning the intermingling of different funds had not been implemented and that copies of financial reports were not being returned from higher management with any comments. The team felt that the resulting lack of communications potentially weakened the working relationship between the two commands.

A finding relating to the size of sales at the barbershop of the activity led to a recommendation that the rent charged to the barbershop be increased to eliminate a subsidy to the barbershop. No justification for the increase was indicated and the elasticity of sales was not considered in the recommendation.

Another finding related to the activity's handling of merchandise. Although the problem was documented, no recommendation was given to improve the situation.

None of the findings contained in the report indicated the extent of the problem or any consequences of the problems. The criteria used in determining potential deficiencies was not given. Few recommendations were adequately supported by information justifying the particular recommendation. No separation was made between findings and opinions of the

audit team and comments from the auditee were not included in the report.

3. USCG Air Base, Elizabeth City, NC (DOT Audit Team)

This report is enclosed in Appendix D. The objectives of this audit, as stated in the report, were to evaluate:

1. policies and procedures for use of non-appropriated funds.
2. accounting procedures and internal controls.
3. management of exchange and club activities.
4. management of loan operations.

While objective number one and number two are related primarily to a financial compliance audit, objectives number three and number four could be related to an operational type audit. However, the findings and recommendations presented in the report tended to emphasize internal controls and compliance with regulations and legal requirements. The audit was conducted in accordance with standards established by the Comptroller General, who is the head of the GAO.

This report differed from the previous two reports in that the scope of the audit was clearly stated. Audited areas included utilities, personal property, administrative practices, cash collections, and morale funds. The report also stated the time period during which a response to the contents of the audit report was to be made by the auditee.

The findings and recommendations in the report were concerned with compliance with existing regulations. Exceptions

were noted in several cases and recommendations were made to upper management describing in detail the necessary corrections. The recommendations included the official comment of upper management in response to the findings and recommendations. All findings were presented in a manner that provided the background to the finding and the particulars of the finding. While the report was in a clear, concise format, it dealt primarily with compliance type findings and did not deal with constructive type findings or recommendations.

D. SUMMARY

As an indication of current Coast Guard audit procedures for NAFA, this chapter has analyzed the guidelines for conducting an audit, the major reports analyzed during the audit, and three actual audit reports from Coast Guard activities.

The next chapter presents the legal requirements for audit programs that are applicable to NAFA and outlines the current level of operations of Coast Guard NAFA in order to establish the need for an operational review program of these activities. A model of an operational audit for implementation in Coast Guard NAFA is then presented.

IV. NEED FOR OPERATIONAL AUDITING

A. GENERAL

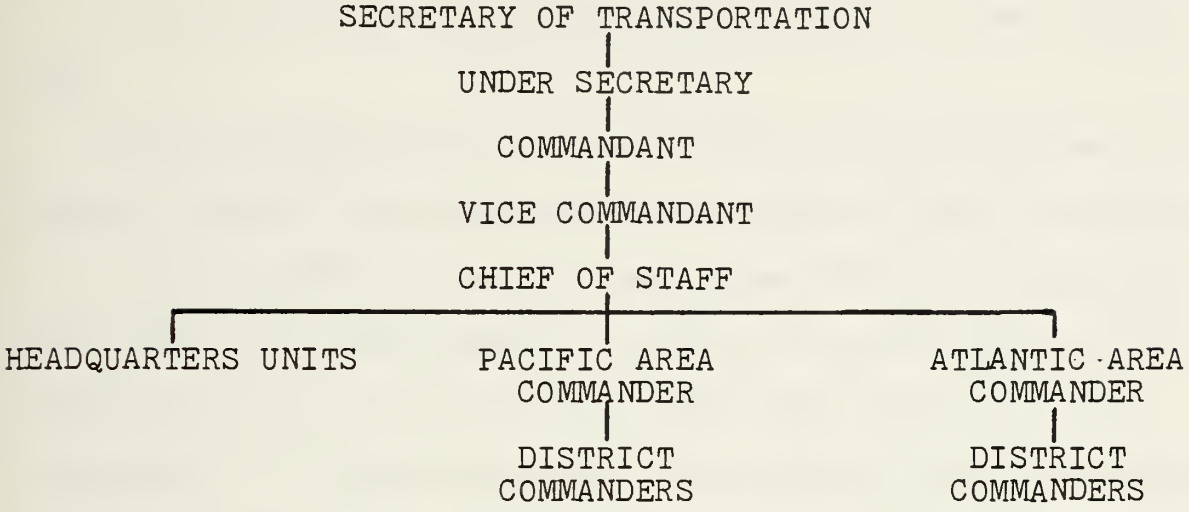
This chapter provides a basis for the need for an operational audit program for Coast Guard Non-appropriated Fund Activities (NAFA). The first section provides a brief overview of the projected gross sales of Coast Guard NAFA as an indication of the extent of their operations. The second section describes the history and current provisions of the Inspector Generals Act as a background for the legal requirements for an operational audit program. The third section briefly analyzes the Department of Transportations (DOT) efforts in implementing an internal audit program. The final section proposes a model based on this need and the standards discussed in Chapter II.

B. CURRENT LEVEL OF COAST GUARD NAFA

There are currently 82 Coast Guard NAFAs with reporting responsibility to higher authority at either the District level or above the District level. Exhibit 4-1 is the basic Coast Guard organizational arrangement. The combined projected gross sales of the NAFAs for fiscal year 1980 is $99,950,000. [Ref 16] The NAFA fiscal year is the period from 1 February through 31 January of the following year. This projection is based on figures submitted by Coast Guard NAFA Officers in accordance with COMDTINST 7110.8 entitled

EXHIBIT 4-1

U.S. COAST GUARD ORGANIZATIONAL CHART



There are twelve Coast Guard Districts as follows:

1st Coast Guard District : Boston, Massachusetts

2nd Coast Guard District : St. Louis, Missouri

3rd Coast Guard District : New York, New York

5th Coast Guard District : Portsmouth, Virginia

7th Coast Guard District : Miami, Florida

8th Coast Guard District : New Orleans, Louisiana

9th Coast Guard District : Cleveland, Ohio

11th Coast Guard District : Long Beach, California

12th Coast Guard District : San Francisco, California

13th Coast Guard District : Seattle, Washington

14th Coast Guard District : Honolulu, Hawaii

17th Coast Guard District : Juneau, Alaska

"NAFA FY 80 Budgeting, Reporting and Accounting Procedures." It addresses a new budgeting system implemented in 1980 and is designed to improve the budgeting process in Coast Guard NAFA.

Of the 82 activities, 25 have gross sales in excess of one million dollars and these activities represent over 87 percent of the total gross sales for Coast Guard NAFA. Of these 25 activities, six have sales in excess of five million dollars and make up 46 percent of total gross sales for all Coast Guard NAFA. It should be noted that some of these gross sales figures include sales figures from satellite exchanges, which are small unit exchanges which are supported by larger exchanges in their immediate home area. Consequently, these figures may not represent the gross sales from an individual NAFA, but the aggregate total of one major activity and several smaller activities.

Exhibit 4-2 is a listing of Coast Guard NAFAs submitting estimated sales figures for fiscal year 1980 and Exhibit 4-3 is a summary of Exhibit 4-2 showing the number of activities with gross sales in excess of certain figures and the percentage of these activities' gross sales in relation to all Coast Guard NAFAs. These larger organizations are often composed of several activities with a relatively extensive staff. For example, the NAFA at the U.S. Coast Guard Academy has assets of $450,000 comprises 14 separate activities with individual managers, and employs approximately 160 people.

Exhibit 4-2

COAST GUARD NAFA PROJECTED
GROSS SALES
FOR
FISCAL YEAR 1980

Cape Cod Air Station	10,550,000
South Portland Base	2,519,000
Boston Support Center	3,000,000
Saint Louis Base	891,000
Brooklyn Air Station	1,603,000
Long Island Group	527,000
Shinnecock Group	302,000
Gloucester City Base	568,000
New York Support Center	6,616,000
Northwind	45,000
Fort Macon Base	25,000
Portsmouth Support Center	1,037,000
Elizabeth City Support Center	3,003,000
Diligence	14,000
Courageous	9,000
Miami Air Station	7,054,000
Clearwater Air Station	1,166,000
Borinquen Air Station	1,853,000
Charleston Base	604,000
San Juan Base	2,380,000
Miami Base	687,000
Mayport Base	807,000
Saint Petersburg Group	6,833,000
Jupiter Loran Station	1,824,000
Dependable	23,000
Durable	14,000
Acushnet	17,000
Mobile Base	2,862,000
New Orleans Base	235,000
Galveston Base	609,000
New Orleans Communications Station	13,000
Houston Port Safety Station	50,000
Little Woods Housing	75,000
Westwind	36,000
Mackinaw	27,000
Bramble	5,000
Mesquite	5,000
Traverse City Air Station	879,000
Muskegon Grup	491,000
Buffalo Group	123,000
Milwaukee Group	129,000
Detroit Group	250,000
Sault Ste Marine Base	73,000
District Nine Exchange	3,093,000

Cleveland Marine Safety Office (mess)	1,451,000
Glacier	85,000
Venturous	11,000
Walnut	14,000
San Diego Air Station	110,000
San Pedro Base	254,000
Humboldt Bay Group	99,000
Polar Star	39,000
Polar Sea	41,000
Port Angeles Air Station	781,000
North Bend Air Station	80,000
Astoria Group	662,000
Portland Marine Safety Office	100,000
Seattle Support Center	318,000
Basswood	5,000
Barbers Point Air Station	35,000
Honolulu Base	2,837,000
Sedge	31,000
Sweetbrier	24,000
Sitka Air Station	325,000
Juneau Station	482,000
Ketchikan Base	409,000
Valdez Marine Safety Office	15,000
Kodiak Support Center	4,106,000
Sellia Marina Loran Station	23,000
Estaritt Loran Station	39,000
Shetland Islands Loran Station	21,000
Lampedusa Loran Station	50,000
Kargabarun Tuslog	9,000
Sylt Loran Station	21,000
Alexandria Station	90,000
Yard	1,052,000
Academy	5,410,000
Cape May Training Center	3,882,000
Petaluma Training Center	1,507,000
Yorktown Reserve Training Center	1,550,000
Alameda Training Center	1,407,000
Mobile Aviation Training Center	9,649,000

Exhibit 4-3

COAST GUARD NAFA
PERCENTAGES
OF
GROSS SALES

Number of Exchanges	Sales in Excess of	Percentage of Total
25	$ 1,000,000	87.4
15	$ 2,000,000	73.8
11	$ 3,000,000	63.2
7	$ 4,000,000	50.2
6	$ 5,000,000	46.1
5	$ 6,000,000	40.7
3	$ 7,000,000	27.2
2	$ 9,000,000	20.2
1	$10,000,000	10.5

As activities increase in size, their growth often leads to the need for more effective internal control procedures and improved management techniques. [Ref 17, p. 393-394] Because of the number of Coast Guard NAFAs with a relatively high amount of gross sales and resultant complexities of operations, an operational review program in the Coast Guard may be warranted in an attempt to improve the operating procedures and management techniques of these larger activities.

C. INSPECTOR GENERALS ACT

1. Prior Developments

The Inspector Generals Act was signed into law on October 18, 1978 by President Carter. However, the concept for an inspector general as reflected in the Act was developed by the Department of Agriculture in 1962. [Ref 18, p. 1] At that time an investigation was being conducted into the activities of Billie Sol Estes by three different investigative units in the Agriculture Department. Because of the lack of coordination in the case, an inspector general was established in the Department, although there was no statutory authority for the office. The office combined the investigative and audit responsibilities for the Department. Except for a short time when it was dismantled by Secretary Butz in 1973, the office has functioned effectively. [Ref 19, p. 8]

The Housing and Urban Development, (HUD); Health, Education and Welfare (HEW); the Veterans Administration (VA); and the

Energy Departments were all agencies or departments which also formed inspector generals office prior to the Act. The inspector generals offices at HUD and HEW were the result of problems in their investigative units that required the development of a comprehensive investigation and audit organization. The inspector generals' office at the Department of Energy was instituted when that department was formed in 1977. The final agency to form an inspector generals' office prior to the signing of the Act was the Veterans Administration which formed an inspector generals' office in January 1978. [Ref 18, p. 3]

Because the established inspector general offices did not have any statutory authority with the exception of HEW and the Energy Department, the offices could be disestablished at any time and lacked the necessary resources for a comprehensive program. A review of other department's investigative and audit functions convinced Congress that a more effective means of preventing fraud and abuse was necessary. For example, in the DOT there were six separate offices conducting investigations and audits. [Ref 18, p. 3] These problems culminated in the passage and subsequent signing of the Act.

2. Provisions of the Act

The Act required the establishment of an Inspector General in twelve major Government organizations and gave statutory authority to the already established inspector general offices. [Ref 18, p. 3] The DOT was included among those

departments that were required to establish such offices. The major provisions of the Act required the department's audit and investigative units to be transferred to the office of the Inspector General, where the Inspector General would provide policy for all audits and investigations as well as oversee all operations. Standards established by the Comptroller General would be applicable to all audits carried out by the departments. The Inspector General was to report directly and immediately to the agency head or an immediate subordinate whenever any "particularly or flagrant violations" were detected, [Ref 18, p. 4] was to be appointed by the President and could only be removed by the President with the consent of the Senate. The Inspector General was also responsible for reporting semi-annually to Congress on all major investigations, corrective action taken, any matters referred for prosecution and was required to submit a copy of each report that was submitted to the Secretary or agency head and a list of all audits completed. The Act also guarantees the confidentiality of all department employees who report possible violations.

3. Effects of the Act

The most advantageous provision of the Act is considered to be the combination of the audit and investigation functions in an agency or department. [Ref 18, p. 5] It was the sponsors of this legislations' hope that this coordination would lead

to a more efficient utilization of both audit and investigation resources. [Ref 19, p. 10] However, the fear was also expressed that the effect of the Act, which was directed primarily at dealing with fraud and abuse, would dilute the audit function of the concerned agencies. [Ref 20, p. 14] A counter view to this argument is that the audit function will be enhanced because the Act will lead to an expansion of audit and investigation resources and will encourage prompt corrective action because of the reporting requirements of the Act. [Ref 20, p. 14] There has been concern over how the Act will affect any Level II or Level III audits in an agency since there is the potential for a clash between these evaluations and the audit functions of the Act.

> If individual IGs become very ambitious, and wanted to get into things like program effectiveness, they would perhaps start to depart from what OMB views as the original intent of the legislation, and the spirit of the Act. . . The economy and efficiency areas are in the middle. That is where program evaluators move toward that center and the Inspector Generals move toward that center and meet. At that time OMB hopes to play a coordination role. . .in developing some operating policies to keep such groups from colliding with each other and fighting over turfs. [Ref 21, p. 71]

Since the Act was signed relatively recently, its impact on the internal control functions of various programs has yet to be assessed.

D. DOT REQUIREMENTS

The DOT has yet to issue department wide policies from the Inspector General's office. Although these policies,

which should cover the entire Department, are in the development stage; at present, guidance for audit conducted by the Department are provided by the five regional offices which are geographically situated in accordance with the standard Federal cities concept. [Ref 22]

> . . .the audits are still done with the cooperation of the units being audited and interim reports are prepared for the Administrators. [Ref 23, p. 149]

Because guidance for the Department's audits come from these Regional offices, the role of the auditor is especially important. It was indicated that most competent auditors are able to develop their own programs based on standards promulgated by the Comptroller General. [Ref 22]

E. MODEL FOR OPERATIONAL AUDITING

The following model for an operational audit of Coast Guard NAFAs is based on guidelines promulgated by the GAO in its publication, "Guidelines for Economy and Efficiency Audits of Federally Assisted Programs" and information presented in Chapter II. The model divides the audit into four aspects: definition of objectives, survey and planning phase, review phase, and the report. Exhibit 4-4 outlines the model.

1. Defining the Objectives

During this phase the specific objectives of the audit are clearly stated. This phase should establish the direction that management wishes the audit to proceed. By establishing the objectives of the audit, the auditor is given some guidance that can help direct the survey phase of the audit.

EXHIBIT 4-4

OPERATIONAL AUDIT STEPS

1. Define Objectives of the Audit

2. Survey the Activity for Auditor Familiarization and Plan the Audit Program (s)

3. Conduct the Operational Review

4. Communicate Results of Review in the Report

The objectives are also able to provide a basis for comparing the actual resutls of the audit with the initially stated objectives.

2. Survey and Planning Phase

The purpose of the survey phase is auditor familiarization. [Ref 10, p. 124]

> . . .survey efforts should be directed at identifying areas where it appears that time, money and other resources can be saved. The focus of the survey work should be on identifying and evaluating the adequacy of management controls of the organization. [Ref 1, p. 9]

During the survey the auditor engages in an education process that is designed "to be a relatively fast process for gathering information, without detailed verification, on the activity or program being examined." [Ref 1, p. 9] Because an operational audit encompasses all aspects of an organization, guidelines for this phase are necessary in order to insure adequate familiarization on the part of the auditor with the organization and deal primarily with means of obtaining information.

After the survey phase, a summary of work completed should be developed to facilitate planning, which involves coordinating the review phase of the audit in order to achieve the desired results.

The scope of the audit should also be established during this time. The scope of an audit establishes the matters which should be reviewed in an examination and the nature and degree of the work to be performed. [Ref 1, p. 11] and is essentially determined by the survey results. Establishing

the scope of an audit requires the examination of the areas previously identified during the survey as being the ones with the greatest potential for improvement, appropriate activities of these areas, and the extent of planned examinations into these activities. Because an operational audit is all encompassing, it is important to include all relevant activities of a problem when planning the audit. Limiting the scope of an audit to only that area or activity which demonstrates the most deficiencies may result in a treatment of the symptom of a problem rather than the actual problem itself.

The rationale for pursuing specified problems in more depth must also be developed. Care should be taken at this point to insure that the potential benefits from pursuing the audit further exceed the costs of performing the audit. Suggested work steps should be established during this phase and the reasons for the particular steps established. Preliminary time estimates and resource requirements should be identified at this stage to allow management to coordinate the work effort. It is especially important that personnel resources be identified since an operational audit depends primarily on the auditor for its success. Target dates for completing the review and the reporting phase should also be estimated during this time. It is essential in the planning phase to allow for the development of sufficient evidence by the auditors to support any opinion, recommendations, and conclusions that they may develop.

3. Review Phase

This phase consists of the actual testing of controls and the development of evidence "to achieve the approved objectives of the assignment in accordance with our prescribed auditing standards." [Ref 24, p. 2-10]

Evidence developed during this phase must meet the standards established by the GAO.

> Evidence is the specific information obtained during our work through observing, interviewing, and examining records. A basic examination and evaluation standard requires that the evidence we obtain be sufficient to provide appropriate factual basis for our opinions, judgments, conclusions, and recommendations. [Ref 24, p. 8-1]

Evidence is categorized as either physical, testimonial, documentary, or analytical. Physical evidence is obtained through inspection or observation of activities, events, or property. [Ref 24, p. 8-1] Testimonial evidence is developed through the collection of letters, or statements, received as the result of questionnaires or interviews. Documentary evidence is the most common form of evidence and is further categorized as either external or internal. External documents are those originating outside the organization while internal documents are those that originate within the organization. Analytical evidence is obtained by either verifying or examining information. Evidence must meet three basic tests of sufficiency, competence, and relevance. [Ref 24, p. 8-4] Sufficiency is that characteristic that leads another person to the same conclusion as that reached by the auditor.

Competence refers to the reliability and validity of evidence. Relevance is that characteristic of being pertinent to the matter at hand.

The documentation of the review phase should be contained in the auditor's working papers. The purposes of working papers are:

1. To provide a systematic record of work performed in carrying out an assignment.
2. To provide a record of information and evidence obtained and developed in support of the findings, conclusion, and recommendations, made on the basis of our work. [Ref 24, p. 19-1]

The audit report is developed based on the contents of the working papers.

4. Reporting Phase

This phase is concerned with the actual reporting to the appropriate activity the results of the audit. The report should contain a description of the scope, noted deficiencies, recommendations, need for further studies, and the auditee's comments concerning deficiencies and recommendations.

F. SUMMARY

This chapter has discussed the level of Coast Guard NAFAs, the provisions of the Inspector Generals Act, and the DOT policy on internal audit programs. The first section indicates that while there are some Coast Guard NAFAs that are relatively small, there are several activities whose size of operations

could warrant an operational audit program. Because the size of an activity can directly affect internal control problems, it is important for these large activities to be provided with the necessary assistance through an operational audit program to improve their operational effectiveness and prevent any potential internal control difficulties.

The Inspector Generals Act emphasized the need for a coordinated audit program by various agencies and of the legal precedence established for such programs. The provisions of the Act indicate that internal audit programs must be effectively coordinated and their authority clearly established.

While the DOT is still developing guidelines in accordance with the Inspector Generals Act, their current policy emphasizes the need for qualified auditors for the effective implementation of an internal audit program.

Standards developed by the GAO were applied in order to develop a model for implementing a Coast Guard operational audit program in NAFA.

The next chapter presents potential audit guidelines for an operational audit program for Coast Guard NAFAs.

V. PROPOSED GUIDELINES

This chapter considers the effect of established guidelines on organizations as a prelude to the development of recommended guidelines for an operational audit program of Coast Guard Non-appropriated Fund Activities (NAFA), based on the model presented in Chapter IV.

A. GUIDELINES CONSIDERATIONS

The establishment of guidelines for auditors, while having potential benefits, can lead to possible dysfunctional consequences for an organization. Guidelines can affect the auditor and the organization since the auditor conceivably will base the audit on the guidelines and thus these guidelines, if properly developed and implemented, can affect the success of an organizations audit program. The next section considers the potential effect of established guidelines on an activity as an introduction to the presentation of various recommended audit programs and checklists for use in Coast Guard NAFAs.

1. Flexible and Inflexible Guidelines

A key problem with established guidelines is the resultant lack of potential flexibility in the activity for both the auditor and audit organization. If either are overly concerned with the guidelines, potential opportunities for improvement may not be recognized. Because an audit program

is basically a control system it demonstrates a characteristic of inflexibility common in control systems. As Russell Ackoff points out, the lack of flexibility can be a serious flaw:

> . . .planners can and do construct control systems that are capable of detecting and correcting for errors whose possibility has been anticipated; that is, they provide controls that determine when an organization has failed to meet its expectations, but do not determine when meeting its expectations constitues a failure. [Ref 25, p. 14]

A weakness of audit programs relating to their lack of flexibility is their tendency to promote the status quo. [Ref 5, p. 617] Since the purpose of audit programs is to insure that auditors comply with existing guidelines and operate in an efficient manner given a certain external environment, [Ref 5, p. 616] audit programs will continue under the conditions upon which they were instituted. It is thus important for the auditor to have the competence, authority, and independence to tailor the audit guidelines to the particular conditions existing at the time of the audit and to the particular activity being audited.

Flexible standards can also have dysfunctional consequences. Overly flexible audit programs can provide only abstract goals for the auditor and thus not provide any guidance as to what higher management perceives as the organizations overall objectives for the audit.

2. Potential Remedies

If the constructive essence of an operational audit is to be realized, both the auditor and the NAFA audit

organization must realize that audit guidelines are merely a framework upon which the auditor must develop a tailored audit program which is suitable to the individual needs of the audited activity. It must be insured that the auditor has the necessary independence and competence to develop an appropriate audit program based on the framework of guidelines. An ideal set of guidelines would therefore indicate to the auditor the direction that the audit organization desires the audit to proceed and not rigidly define the audit process in such a manner that the constructive and evolutionary nature of an operational audit are negated. The following sections develop some potential audit programs for an operational audit of a Coast Guard NAFA, however it should be realized that they should be treated only as a framework for an audit to be developed later by the individual auditor.

B. DEFINING THE OBJECTIVES

Based on standards developed by the General Accounting Office (GAO), and the information presented in Chapter II, the author recommends the following guidelines for setting audit objectives.

The objectives of the audit should be clearly established in writing when the NAFA audit is first scheduled by management. Although a comprehensive audit of the entire NAFA may be desirable, time and other restraints may preclude a thorough examination of every segment in the NAFA organization. In

such cases, the objectives of the audit should establish the perimeters around the audit project so that the audit program can be developed in accordance with the central theme of the audit. Such a narrowing of the audit project can help insure that the audited segments of the activity are examined in a thorough manner, thus guaranteeing the quality of the audit project. The audit objectives should thus establish those segments of the activity where the most cost-effective improvements can be made.

C. SURVEY PHASE

Based on standards developed by the GAO and the information presented in Chapter II, the author recommends the following guidelines for the survey phase and planning of the audit.

The first step in the survey phase is the contacting of the NAFA officer in order to inform him or her about the auditor's responsibilities, the objectives of the audit, and how it will be conducted. Potential trouble spots can also be identified by the NAFA officer during this phase that may warrant the auditor's attention as well as other pertinent information.

The second step is the interviewing of other personnel involved with the organization. This should include interested third parties, NAFA personnel, and others who are outside the organization with a knowledge of the NAFA organization.

The auditor should also become familiar with previous auditors or other inspection personnel and their views of potential problems and operating procedures.

While interviews provide information concerning an organization, a more time effective means of gathering information is the use of a questionnaire. However, any responses obtained through the use of a questionnaire or an interview should be verified through other means, such as an on-site inspection.

> The auditor should be alert to signs of waste or ineffectiveness that indicate weaknesses warranting further inquiry. Work backlogs, excess equipment or material, idle personnel, extensive repair of equipment, out-dated work methods and machines, and poor working conditions are examples. [Ref 1, p. 11]

Another means of obtaining information is through the use of management's own reports since information useful to management is often useful to the auditor. Items such as budgets, operating statements, activity cost reports, etc., provide insights into the efficiency of an operation. Management reports also point to potential deficiencies in internal control procedures. Prior audit reports are also ways of determining previous problems in the NAFA organization and potential insights into internal operating procedures.

During the survey phase, the auditor may also wish to test internal controls by testing certain transactions. Although such a process is usually done in the review phase, such tests can familiarize the auditor with how certain operating procedures actually function.

An excellent method for familiarization with internal controls and for determining control weaknesses is through the use of flow charts. A flow chart is a visual representation of the internal procedures involved in a specific transaction. Consequently, a flow chart allows the auditor to visualize internal control procedures and the organizations structure. However, when flow charting is used, it should utilize standard symbols to prevent confusion.

D. REVIEW PHASE

1. General

Each segment of a NAFA activity, such as the personnel, accounting, property management, or procurement segments of the NAFA organization has its own unique aspects and characteristics that must be recognized by the auditor during the review phase. However, even though each segment requires a special treatment, a generalized approach can be used in developing broad guidelines for each segment. This general treatment consists of four parts: the nature of the segment, its major control points, special problems unique to the segment, and the auditors role during a review of the segment.

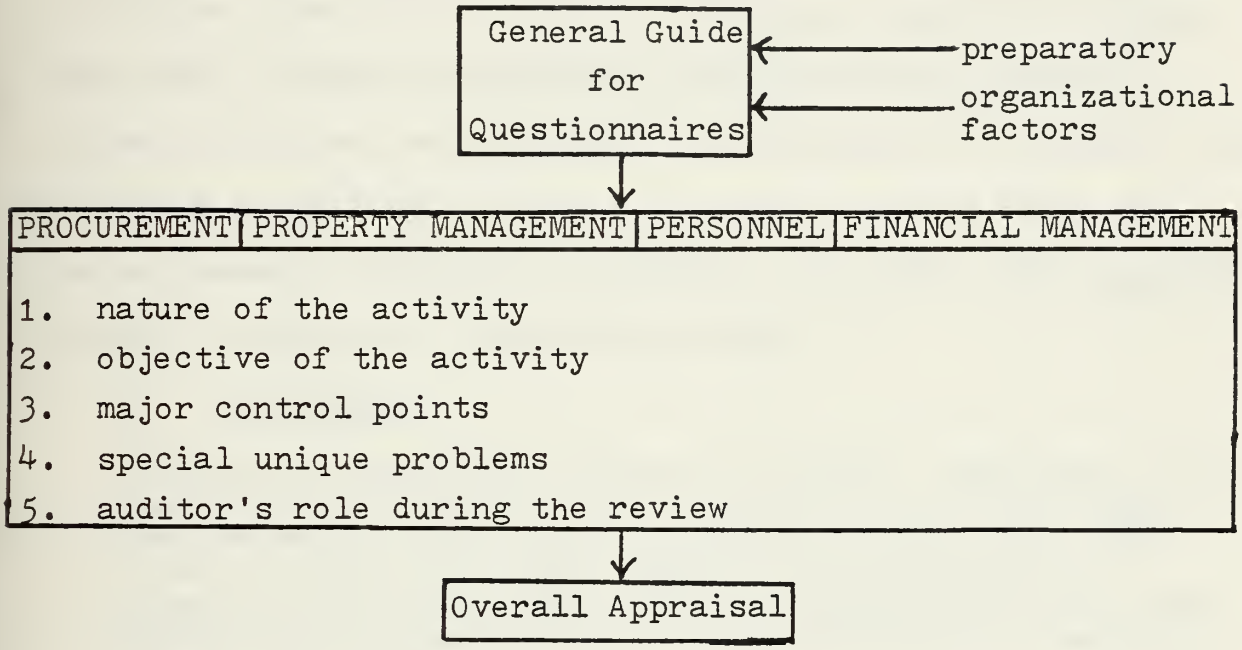
The general nature of the segment describes the functions served by that segment and its broad objectives. The major control points of the segment are described so that during the review phase, the auditors may be cognizant of the preferred practices that are common in similar segments in different

organizations. The third part discusses any problems which are especially prevalent in the particular segment. The final part examines the auditors specific role in connection with a review of the segment. The purpose of this general method is to provide a consistent approach for each segment as a means of extending the role of the auditor by providing a procedure for analysis that can be adapted by an auditor in any situation. The purpose of these descriptions is to provide the auditor with the necessary background to allow him or her to utilize the questionnaires in an intelligent and competent manner. Consequently, each segment includes a generalized questionnaire for use an an audit guide. These guides are meant to be a convenient summary-type reference and are not a substitute for a detailed discussion with appropriate personnel. Exhibit 5-1 shows the review phase organization.

In general there are two types of questionnaires. The first type of questionnaire describes specific types of actions to be taken. This is a general questionnaire and should be adapted to the activity being reviewed based on any unique situations and the auditors judgment. The second type, which is comprised of questions concerning particular aspects of the activity being reviewed, should be used as a means to further inquiry and should not be dealt with on a "yes" or "no" basis.

EXHIBIT 5-1

REVIEW PHASE ORGANIZATION



The review phase organization was developed from Modern Internal Auditing, by V. Z. Brink, J. A. Cashin, and H. Witt, New York: John Wiley & Sons, Inc., 1973.

> The result desired is careful investigation and critical appraisal, with the subsequent determination of any significant deficiencies, and the opportunities for bettering the operation in some worthwhile manner. [Ref 5, p. 121]

Exhibit 5-2 is a general audit guide which corresponds to the procedures common to all audits of various segments of Coast Guard NAFA. Based on standards developed by the GAO and information presented in Chapter II, the author recommends the following guidelines for the review phase of the audit for the procurement, property management, personnel, and financial mangement segments of Coast Guard NAFA.

2. Procurement

> Effective procurement involves planning, organizing, and managing to obtain goods and services in an efficient and economical manner. If volume is substantial, the cost of ineffective procurement practices may be significant. Conversely, effective practices facilitate smooth operations and result in efficiency and economy. [Ref 3, p. 161]

Procurement is concerned with obtaining "the right product at the right price, in the right quantity, and at the right place." [Ref 9, p. 44] The procurement or purchasing segment of a NAFA is especially important since the volume of purchases is a determinant of inventory levels which in turn is a major factor in achieving a favorable return on capital employed. Unfortunately, an objective review of this activity is difficult since the determination of "right", which signifies the "best possible" considering current factors and the long term interests of the activity, cannot be precisely evaluated.

EXHIBIT 5-2

AUDIT GUIDES

COMMON TO ALL OPERATIONAL AREAS

1. Introductory
   - A. As previously discussed, the nature of audit guides as broad guide lines to the development of definitive audit programs should be recognized.
   - b. The entire audit program needs to be adapted to the functional or organizational scope of the review.

2. Preparatory Activities
   - A. At home base
     1. Discuss timing and scope of planned review with the officer to whom the manager of the activity reports. Determine if there are any questions or suggestions.
     2. Review reports, working papers, and subsequent development aspects in audit files covering last review.
     3. Determine what other individuals should be contacted before beginning the actual review, and arrange and complete such contacts. Determine if there are any questions or suggestions.
   - B. At the Office of the manager of the Activity
     1. Explanation of scope of planned review.
     2. Determinations of the manager's concept of the activity, its role, objectives, and special problems.
     3. Determine if there are any questions or suggestions.

3. Organizational Factors
   - A. Organizational Relationships of the Activity with Other Units
     1. To whom does the head of the Activity report?
        - a. Is this reporting satisfactory in terms of that individual's other responsibilities?
        - b. Is the organization level sufficiently high?
     2. Establish that the Activity is independent of the other Units from which it receives input and to which it provides output.
     3. Obtain and appraise for adequacy all statements of mission, organizational purpose, and major policy relating to the Activity.
     4. To what extent is the responsibility for various types of activities by the Activity made clear?
     5. To what extent do committees or other organizational components participate in the control over policy?

6. Is the primary mission of this Activity being fulfilled?
7. Are there letters on file approving the establishment of this Activity and all of its branches?

B. Organizational Relationships within the Activity
1. Obtain and review a copy of the organization chart for the Activity. Are the assignments of responsibility clear and reasonable for effective internal control?
2. Review and appraise the adequacy of supporting job descriptions.
3. Review and appraise the adequacy of manuals covering policy and procedures.

4. Operational Activities
To be developed, as required, for each operational activity.

5. Overall Appraisal of Activity Effectiveness
A. Examination of Reports Rendered:
1. To appraise adequacy of scope.
2. To confirm accuracy of data being reported.
3. Adequacy of backup for reported results.

B. Program of Goal Achievement
1. Adequacy of program for establishing and updating operational goals.
2. Extent of achievement of projected goals.

C. Relations with other Unit Activities
1. Adequacy of coordination with other unit activities to achieve operational effectiveness and maximum Unit benefit.
2. Evidence of close relationships with higher level management for maximum contribution to overall activity planning and performance.

D. Relations with Outside Parties
1. Evidence of efforts to relate effectively to outside parties in current operations.
2. Adequacy of effort to exploit longer term dimensions of achieving greater mutual profitability.

E. Appraisal of People Utilization
1. Levels of turnover.
2. State of morale.
3. Order and efficiency.
4. Cost performance.
5. Proper use of qualifications of personnel.
6. Effectiveness of key personnel.

Exhibit 5-2 (cont)

F. Extent of Major Problem and Opportunities
   1. What, if any, are the major areas of difficulty? What are the causes and possible remedies?
   2. What are the major areas of improvement? And what action is needed?

This audit guide was adapted from an audit guide presented in Modern Internal Auditing, by V. Z. Brink, J. A. Cashin, and H. Witt, New York: John Wiley & Sons, Inc., 1973, p. 122-124.

The purchasing segment can be divided into three areas: clerical, selection of vendors and negotiation of prices, and the extent to which opportunities are taken in improving the condition of the operation. The clerical area is concerned with the proper completion of purchase documents or forms. The selection of vendors and negotiation of prices is concerned with the actual purchasing of an item. The extent to which opportunities are taken in improving the condition of the operation is a managerial responsibility that is concerned with being sensitive to market conditions.

In addition there are six major functions usually found in a purchasing segment: determination of needs, authorization, the making of the purchase, the follow up, the delivery, and financial settlement. Each one of these functions has a control point that is essential for a smoothly functioning NAFA.

a. Determination of Need

> The basic control issue in the determination of needs is the extent to which that determination is made on a sound basis and then accurately communicated to the purchasing group. [Ref 5, p. 127]

Typical determinations include a pre-determined economic order point for commonly stocked items or managements decision concerning the addition of a new stock item. In the determination of need, key underlying factors are either the validity of the need or the marketability of the item in question. Although the determination of need normally would not originate in the

purchasing group but with management; the purchasing group, since it is in touch with market conditions and individual vendors, is nevertheless in an advantageous position to determine the validity of the need. Consequently, purchasing personnel should be able to give important advice to other organizational personnel concerning changing developments and the consequences of the developments on the NAFA.

b. Authorization of Purchase

After the determination of needs and the completion of requisitioning documents, a clerical function, the purchase must be authorized. The basic control issue in the authorization function is that a determination be made that the stocking of the item is in the best interest of the activity and in keeping with established policy.

c. Making of the Purchase

The basic function of the purchasing branch is the actual making of the purchase. This involves the search for an appropriate vendor, the establishment of a price, and the arrangement for delivery of the item. Important considerations concerning the selection of the vendor consist of:

1. The diligence of the search for all qualified vendors.
2. The individual vendor's reliability in terms of past procurements, general reputation, and financial standing.
3. The weighing of the various factors that comprise the determination of the value to be received. This will include price, terms absorption of delivery costs, maintenance of reserve inventories, capacity to satisfy delivery requirements, quality, service backup, product development activities, and the like.

4. The extent to which there are supplementary considerations like community relations, support of small business or minorities, competitor disclosure risks, or government direction.

5. The extent to which the activity desires protection for supply through dual or multiple sourcing. [Ref 5, p. 129]

The basic control factor for this function therefore is whether the purchasing branch has fully exploited market opportunities. This means that the purchasing group has used every legitimate competitive pressure to obtain the maximum value for the activity. A key factor in this function is that the buyer not favor any one vendor because of any undue influence by the vendor.

> The types of pressure run from legitimate sales presentations and persistent follow-up to friendship factors, to entertainment, to gifts, and on to various types of actual bribery. [Ref 5, p. 137]

Procedural aspects of the purchase documents are contained in Exhibit 5-3, which is a questionnaire for the purchasing segment.

d. Follow-up on Purchase and Delivery

After the purchase has been contracted for, the purchasing branch is concerned with the actual delivery of the items in accordance with the purchase order agreement. The basic control factor for this function is whether the buyer monitors the performance of the contract by the vendor. This is a control factor since in order to achieve a separation of responsibilities, it is important for the purchasing branch to be separate from the receiving branch of the activity. Consequently, while it

EXHIBIT 5-3

PROCUREMENT AUDIT GUIDE

1. Introductory
   A. Reference should be made to the general discussion of audit guides in Exhibit 5-2.

2. A. See standard audit guide in Exhibit 5-2.

3. Organizational Factors
   A. See standard audit guide in Exhibit 5-2.
   B. Establish that the purchasing branch is independent of receiving, inspection, stores, and accounts payable activities.
   C. Matters of special interest in the review of purchasing policy will include:
      1. standards of vendor relationships
      2. competitive bidding requirements
      3. extent of multiple sourcing
      4. extent of local purchases
      5. authorized levels of approval
      6. conflict of interest and acceptance of gifts.
      7. follow-up responsibilities
      8. handling of deviations from established procedures.

4. Authorization for Purchase
   A. Review the procedures for authorizing purchases. Points of special interest include:
      1. who initiates the purchase?
      2. what approvals are necessary for particular types of items and amounts in terms of either quantities or dollar values?
      3. what forms are to be used? are they serially numbered?
      4. how are supplementary approvals handled when actual purchase cost exceeds original estimates?
      5. what provision for changes in specifications or quantities?
   B. On the basis of actual tests, verify and appraise:
      1. the extent to which the procedures are complied with. (Where they were not complied with to any significant degree, what were the causes?)
      2. Do the procedures appear to be adequate?
      3. Where there are unusual authorizations in terms of types of products, quantities, source restrictions, etc., does it appear that these are questioned and discussed?
      4. the extent to which advantage is taken of 'Specials' without overbuying.

5. the extent to which great care and judgment is used in the selection of merchandise for resale.
6. the extent to which only authorized merchandise is procured for sale.

5. Internal Operations
   A. General
      1. Are the facilities adequate:
         a. for reception and interviews with vendor representatives?
         b. for internal operations?
      2. Are the internal operations being carried out in a manner consistent with established organizational responsibilities, policies and procedures? If not, what are the causes, and what kind of corrective action seems to be warranted? This part of the review would include such questions as:
         1. should the organizational responsibilities be modified?
         2. should operational policies be reappraised?
         3. should operational procedures be revised?
         4. do we need different people?
      3. To what extent do the operations reflect a high degree of efficiency and morale?
      4. Are internal records and files of various types adequate in terms of special purpose and relation to other records and procedures? Are they being maintained efficiently?
      5. Is the total purchase cycle adequately controlled as to receipt of authorization, assignment to buyer, making of purchase, follow-up, and completion - so that the status of individual procurements can be easily determined?
      6. Are purchasing forms properly safeguarded and controlled?
      7. Are purchasing actions being processed on a timely basis?
      8. Are verbal orders confirmed by written confirmation purchase orders?
   B. Relating to Vendors
      1. Are adequate vendor records maintained showing supply capabilities and continuing purchasing relationships?
      2. How adequate is the effort to develop new vendor sources?
      3. What efforts are being made to evaluate vendor performance for price, delivery, and quality? and are adequate files pertaining to these factors maintained?

4. How adequate are the efforts to work with vendors to study cost reduction possibilities?
5. If price lists of vendors are used, are they updated with reasonable frequency?
6. Does the activity tend to stay with best sellers and name brands?
7. Does the activity buy and take advantage of Price Agreement Bulletins?
8. Is enough lead time allowed the purchasing branch to 'shop the market'?
9. Are there any indications of favoritism to vendors?

6. Special Audit Tests
   A. In addition to such observations and queries as have been made relative to specific aspects, it is desirable to test a representative number of purchase transactions by following them through all steps in the purchasing cycle. The sample should be picked at random from the original input of authorizations to purchase. Points of special interest at all stages would include:
      1. compliance with all policies and procedures.
      2. reasonableness of timing at the various stages
      3. evidence of care and maximum protection of activity interest.
      4. evidence of good team work in the total purchasing group.
      5. all possible evidence of good value received.
      6. excessive rush or emergency orders.
      7. possibilities for combining separate purchases
      8. orders for unauthorized items
      9. effectiveness of internal records and related procedures.
      10. leads for matters to be investigated in the review of other operational activities.
      11. any evidence of vendor favortism.
      12. overall evaluation of the competence of the management of the purchasing activity.

7. Data Processing
   1. Are there purchasing functions that have been adapted to electronic data processing?
   2. If no, are there areas that should be computerized?
   3. If yes, what are the benefits from computerization?

Exhibit 5-3 (cont)

8. Overall Appriasal of Purchasing Effectiveness
   A. See standard Audit Guide, Exhibit 5-2
   B. Appraisal of relations with both vendors and activity should focus especially upon reduction of costs through modifications of production processes, different delivery arrangements, and the like.

This audit guide was adapted from an audit guide presented in Modern Internal Auditing, by V. Z. Brink, J. A. Cashin, and H. Witt, New York: John Wiley & Sons, Inc., 1973, p. 139-143.

Additional material was adapted from the following books:

F. Pomeranz, A. J. Cancellieri, J. B. Stevens, and J. L. Savage, Auditing in the Public Sector, New York: Coopers & Lybrand, 1976, p. 173-179.

B. Cadmus, Operational Auditing Handbook, New York: The Institute of Internal Auditors, Inc., 1964, p. 76-82.

is important for the purchasing branch to be kept informed concerning any deliveries, the major concern for the auditor is the separation of responsibilities between the purchasing and receiving branch in regard to monitoring deliveries.

e. Payment Function

The final function concerning the purchasing branch is the financial settlement of the purchases. This function's control factor is also related to the separation of responsibilities since its major concern is that the accounts payable groups be separate from the purchasing group.

f. Auditor's Problems and Role

A special problem concerning the auditor is the difficulty in measuring the effectiveness of the purchasing branch. Although surrogate measures such as the number of purchase orders per month, etc., are available, the essence of the effectiveness of the purchasing branch is in the judgment of the buyers. Indications as to the effectiveness of the branch are evident in signs of cooperation and coordination with other branches, good relationship with vendors, efficient routines in relation to results, and small inventory write-downs at the close of the fiscal year. [Ref 9, p. 52]

The role of the auditor should follow this pattern:

1. understand the nature and scope of the purchasing branch.
2. check on the existence of administrative policies and of the compliance with these policies.
3. appraise those policies and procedures in terms of improvement.

4. seek to identify the management service potential as purchasing works in a collaborative partnership fashion with both vendors and operational managers of the activity.

5. seek to contribute to increased activity welfare through identifying any other means by which the purchasing effort can be made more effective. [Ref 5, p. 139]

3. Property Management

The property management branch is concerned with the assurance that:

> . . .adequate equipment and supplies are available and are being used, controlled, maintained, and replaced in an economical manner. [Ref 1, p. 20]

Most NAFA operations have substantial investments in their inventory, equipment, and physical facilities. In considering the control of these assets, management must continually consider the effect of controls on the productivity of the assets.

The general nature of the property management branch is one of insuring that the activity has adequate control on its equipment and inventory in order to prevent spoilage, pilferage, and general decay due to lack of maintenance. Thus, the property management branch has three basic functions: the receipt and control of equipment of supplies, the control of the use of facilities, equipment, and supplies, and the maintenance of equipment and facilities.

The purpose of the first function is to insure that the activity has the desired type, quality, and amount of equipment, supplies, and inventory available for use.

The second function is concerned with the proper use of all available supplies, and equipment. The third function is concerned with the proper maintenance, both preventive and corrective of equipment to insure that it is maintained at the least cost and is available for use by the activity.

a. Receipt and Control of Equipment and Supplies

This function deals with the adequacy of the inventory control system, which in turn is concerned with the effectiveness of the property records. The control points for this function are thus concerned with the responsibility for property and the taking of physical inventory.

All equipment, supplies, inventory, and property should be assigned to an identifiable individual who is charged with the accountability of the particular item. This function is particularly concerned with the assignment of responsibility for supervising the inventory and the compliance with existing control procedures for the safeguarding of inventory.

The verification of property records is an indication of how well the system is actually working. Differences between the actual inventory and the property records provide the basis for determining the underlying causes of the discrepancy. The verification of the inventory also allows an objective appraisal as to how well the current condition of the inventory is being maintained. Thus, the verification provides a good appraisal of the adequacy of property records and of the maintenance of property and inventory.

b. Control of the Use of Facilities, Equipment, and Supplies

This function is concerned with the administration of equipment and facilities. It includes an analysis as to whether equipment and facilities are either being fully utilized or being utilized in their intended manner. The security, fire, and safety procedures in effect are also important factors in determining the usability of equipment.

A problem concerning the use of equipment is whether the operators of the equipment are properly trained and/or skilled to properly operate the equipment. Another problem is whether the equipment is operating up to its expectations and whether it could be effectively replaced with less expensive equipment or could be replaced with more effective, but more expensive, equipment.

c. Maintenance of Equipment and Facilities

This function deals with whether equipment is maintained in a state that allows its daily operation in such a manner that it does not detract from the operations of the activity. A problem concerning the maintenance of equipment is whether maintenance is more cost effective than the replacement cost of the particular item. Consequently, the auditor must be cognizant of the implications and relevance of cost-benefit relationships for maintaining a piece of equipment versus replacement of the equipment.

d. Auditor's Role

A key role of the auditor concerning property management is the determination of compliance with existing regulations or policies, the adequacy of the policies, and the extent to which they can be improved. The method of inventory verification and appraisal should be examined to determine if more cost effective methods of determining inventory can be implemented.

The auditor must be concerned with the basic property records to insure that new property or inventory records are properly maintained and that custody of all appropriate equipment or inventory is appropriately accounted for at all times. Of special importance is a change in location of certain property or inventories. Care must be taken by the auditor to insure that such transactions are properly recorded by the inventory management system.

If statistical sampling techniques are used for inventory determinations, care should be taken that they are appropriate and are being properly applied. While the utilization of statistical techniques can be cost effective, they are not fool proof techniques that relieve the auditor of responsibility. Exhibit 5-4 contains the questionnaire and checklist for this branch.

EXHIBIT 5-4

PROPERTY MANAGEMENT

1. Introductory
   A. Reference should be made to the general discussion of audit guides, Exhibit 5-2.

2. Preparatory Activities
   A. See Standard Audit Guide, Exhibit 5-2.

3. Organizational Factors
   A. See Standard Audit Guide, Exhibit 5-2.
   B. Establish that the store department is independent of purchasing, receiving, inspection, and accounts payable departments.
   C. Matters of special interest in the review of established policy will include:
      1. determination of ordering criteria.
      2. receiving of materials into stores.
      3. storage of materials.
      4. release of materials from stores.
      5. coordination with other organizational components.
      6. authorized levels of approval.
      7. handling of deviations from established procedures.
      8. handling of obsolete and damaged material.
      9. inventory records.
      10. physical verification of inventories and book records.

4. Determination of Needs
   A. Currently Existing Design
      1. Who is responsible?
      2. What is the basis of the determination?
         a. Is the coverage of pertinent factors adequate?
         b. Has the mathematical basis of existing models been backed up by adequate expertise?
         c. Has it been approved by an adequate level of authority?
      3. Are the various types of materials adequately covered?
      4. What supplementary day-to-day approvals are specified as the results of the designed approach are translated into actual procurement orders?
   B. Current Operation of the Design for Determination of Needs
      1. How often is the basic design reviewed, and is this reasonable?
      2. Review the adequacy of input data used in the basic design.
      3. Review a representative number of individual inventory balances to determine the extent to which the basic design appears to be producing reasonable results. Have writeoffs for obsolete materials been reasonable?
      4. Are stipulated approvals being actually required?

EXHIBIT 5-4 (cont)

5. Internal Operations
   A. Incoming materials
      1. Are the items being handled adequately from a physical standpoint?
      2. Is security adequate?
      3. What are the procedures for handling damaged materials?
         a. who is notified?
         b. who authorizes rejection?
         c. how are materials segregated?
         d. how is disposition handled, and who is responsible?
      4. What are the procedures for handling overshipments?
         a. who is notified?
         b. how are materials segregated?
         c. how are they disposed of?
      5. What are the procedures for handling valuable or specially attractive items?
      6. How are after-hour deliveries handled and reported?
      7. From materials being held in the Receiving Department, a selection should be made to include, where possible:
         a. materials which cannot be identified with purchase orders.
         b. materials to be returned to vendors.
         c. damaged materials.
         d. materials being held for any other reason.
         e. materials held for an undue length of time.
         The auditor should determine whether reporting, follow-up and other procedures are being followed.
      8. Are accountabilities being properly transferred through counts and sign-off of transfer papers?
      9. Are book records promptly and accurately posted?
   B. Storage of Materials
      1. Are facilities and equipment adequate?
      2. Is the overall approach sound for the location of specific materials?
      3. Are materials being promptly moved to assigned locations?
      4. Is storage area orderly and is there adequate access?
      5. Is security adequate?
         a. are there letters on file designating persons who have custory of keys to each space?
         b. does any unauthorized persons have key to these spaces?
         c. are adequate fire and safety procedures in effect?
      6. Determine if supplies that are susceptible to deterioration are properly rotated to protect against loss.

C. Taking of Inventory
   1. Verify that inventories are taken according to established policy.
   2. Test-count a sample of inventory items. Trace test counts to final inventory compilation.
   3. Vouch unit prices to vendors' invoices.
   4. Recalculate extensions and footing of the final inventory compilation.
   5. Inquire about obsolete or damaged goods subject to write-down or write-off. Scan perpetual records for slow-moving inventory.
   6. Check physical counts with quantities recorded on the property records and investigate differences.
   7. Determine if the location of material agrees with the property records.
   8. Account for items sold or surveyed since the last physical inventory, and trace journal transactions, for the proceeds, if any were received.
   9. Determine what the procedures are for surveying goods.
   10. Verify that the procedures are complied with.
   11. Determine the authorization procedures for surveys.
   12. Vouch entries on the property records to their source documents.

D. Release of Materials
   1. Is the collection of materials for release phase adequately handled:
      a. as to authorizing paper to collectors?
      b. as to care in collecting individual materials, both as to accuracy of count, and physical handling?
   2. Is release procedure adequately handled:
      a. as to reasonable recheck of accuracy of collection?
      b. as to procedural transfer of accountability?
      c. as to posting of inventory records?
      d. as to adequacy of security?
   3. Are low stock developments used as alerts for checking on new materials?

6. Overall Appraisal of Stores Effectiveness
   A. See standard Audit Guides, Exhibit 5-2.

Exhibit 5-4 (cont)

This audit guide was adapted from an audit guide presented in Modern Internal Auditing, by V. Z. Brin, J. A. CAshin, and H. Witt, New York: John Wiley & Sons, Inc., 1973, p. 166-169.

Additional material was adapted from the following book:

B. Cadmus, Operational Auditing Handbook, New York: The Institute of Internal Auditors, Inc., 1964, p. 250-254.

4. Personnel

The overall goal of the personnel function is:

> . . .to identify people with management potential early in their careers; to encourage the growth and development of all employees; to provide jobs that enable the jobholder to experience a sense of satisfaction and achievement; and to supply the organization with a continuing supply of competent, imaginative, well qualified management people. [Ref 3, p. 132]

This section treats the management of employees, which includes monitoring of work performance by management personnel, and the traditional personnel function which handles the administration of employee records and the recruiting of potential employees. Although the size of many Coast Guard NAFA does not warrant the establishment of a separate personnel function for the activity, nevertheless the effectiveness of an activity "is largely dependent on the quality and responsiveness of the people that carry out operations." [Ref 3, p. 132] This section is concerned with the personnel function, regardless of whether it is established as a separate entity in the activity or is performed as a collateral duty by various activity personnel.

Effectiveness for the personnel function requires the balancing of two potentially conflicting needs: the needs of the activity in achieving its goals or objectives and the personal needs of the employees of the activity. The essence of the personnel function is thus directly related to the total management function of the activity. The balancing of abstract employee personal needs with the relatively rigidly

defined needs of the activity often results in the personnel function being an all inclusive function that is interwoven with the entire activity and management process.

There are four major functions in the personnel segment: identification of manpower needs, recruiting and hiring, training and development, and performance appraisal and promotion. [Ref 3, p. 133]

a. Identification of Manpower Needs

Before the recruiting of personnel can take place, the activity must identify its manpower needs. This would usually require the establishment of a position classification system.

> A position classification system defines particular jobs in terms of the functions and responsibilities they entail, and the skills and capabilities needed for the job. [Ref 3, p. 132]

This structure should reflect managements' judgment as to how tasks should be divided up and assigned to particular employees at all levels. From this basic plan, the manpower needs of the organization can be derived. The basic control point for this function is that the determination of manpower needs be carefully and systematically done and that it be kept current through periodic updating. This control point can effectively provide direction for the entire personnel function.

b. Recruiting and Hiring

The recruitment operations begins with a determination as to where the most-qualified personnel can be found and how they can be contacted. Typical approaches include the

completion of application forms, references, special tests, and personal interviews. The concern in this control point is that policies and procedures be in effect and be followed to insure that all qualified individuals are given an equitable chance at employment. This means that all evaluations must be supervised to insure compliance with policies and procedures.

c. Training and Development

The training and development function of the personnel branch is required if the organization is to maintain a level of competence in its employees necessary for effective operations. The activity should have standard procedures for new employees that familiarize them with the administrative policies and procedures of the activity and acquaint them with the various aspects of their jobs. The overall objective of training and development is therefore the achievement of greater usefulness and capability on the part of the employees being trained. The control aspects of training include:

1. The need for continuous management involvement and support.
2. The design of training programs that are both properly coordinated with operational needs and based on adequate professional standards.
3. The careful and sensitive administration of actual training programs to assure good motivation and interest. [Ref 5, p. 305]

d. Performance Appraisal and Promotion

The evaluation of employees performance serves two purposes: a partial basis for determining the ideal future utilization of the individual and the determination of what can be done to decrease the individuals current limitations and increase their overall competence. A key problem in any performance evaluation is that most managers prefer not to evaluate their subordinates or to explain their evaluation to their subordinates which decreases the potential utility of the evaluation process. The control aspects of performance evaluation therefore is to insure that objective evaluations are being conducted in accordance with activity policy and the results communicated to the employee.

e. Auditor's Role

Because the personnel function affects individuals in a personal way, it is often the subject of numerous complaints. Consequently, the evaluation of the personnel function must differentiate between complaints from disgruntled individuals and legitimate complaints. As with other functions, there is no appropriate evaluative criteria with which the auditor can analyze the personnel function. However, good morale, low employee turnover, and operational efficiency are indications of the efficiency of the personnel function.

The potential contributions of the auditor to the activity in the personnel function consist of:

1. The appraisal of the operational efficiency of the various types of programs, operational procedures, and records carried out by the personnel group.

2. The extent to which the personnel group works in a collaborative fashion with the staff and line managers who have the primary people responsibilities.

3. The extent to which otherwise sound personnel policies and procedures are being applied effectively in a managerial sense in individual operational areas of the company. [Ref 5, p. 315]

Of prime importance is the attitude of the auditor since this function is not only important to the success of the NAFA but is an especially sensitive area for both management and employees. Exhibit 5-5 is the basic questionnaire and checklist for this activity.

The auditor must also be sensitive and alert for indications of any type of favoritism or discrimination and be aware of potential union affairs including the interpretation of union agreements and of the activity's compliance with these agreements.

5. Fiscal Administration

Fiscal administration can be divided into two major groups: one dealing with basic financial control and the other dealing with the financial management of the NAFA. Although the two groups are often conducted by the same organizational segment of the activity, they will each be treated separately since the former is more of a clerical function while the latter is more of a managerial function.

EXHIBIT 5-5

PERSONNEL

1. Introductory
   A. Reference should be made to the general discussion of audit guides, Exhibit 5-2.

2. Preparatory Activities
   A. See standard Audit Guides, Exhibit 5-2.
   B. Because of the sensitivity of personnel activities, special care is needed on the part of the auditor.

3. Organizational Factors
   A. See standard audit guide, Exhibit 5-2.
   B. Matters of special interest in the review of personnel policies will include:
      1. Manpower planning.
      2. Recruitment policies and procedures.
      3. Training policies.
      4. Job analysis and evaluation.
      5. Compensation policy.

4. Personnel Planning and Development
   A. Manpower Planning
      1. Review and appraise the adequacy of the policies and procedures for the current determination and projection of manpower needs.
         a. Does each manager adequately participate?
         b. Is there proper coordination with all interested staff and line components?
      2. Review and appraise the adequacy of the assessment of currently existing employee resources and the developing expectations over the planning period.
         a. Does each manager evaluate the personnel for which he or she is directly responsible?
         b. Are results systematically matched with needs to show existing and projected gaps?
         c. Do manpower projecting assessments give consideration to:
            1. the short- and long-range plans of each department?
            2. attrition?
            3. promotions and transfers to other departments?
            4. new skills that may be required?
            5. transfers or other dispositions of excess employees?
            6. innovations that may reduce personnel needs?

d. Are periodic analysis made to determine if work being done is essential?
e. Are positions filled when a need exists rather than when a vacancy occurs?

B. Recruitment and Selection
1. Is recruitment centralized and/or coordinated properly to avoid duplication of effort and inconsistent procedures?
2. Review and appraise the procedures followed for the various types of recruitment.
a. Do organizational components being served participate adequately in the final selection?
b. Are customer groups satisfied with the service being provided? If not, why not?
c. Are records and files relating to recruitment being efficiently maintained?
d. Does the recruiting system provide for:
1. the use of position descriptions?
2. consideration of present staff to fill open positions through promotion or transfer?
3. controls to ensure compliance with
a. applicable laws and regulations?
b. the personnel budget?
e. Does the recruiting system include:
1. Completion of standard application forms?
2. Testing of applicants for technical positions?
3. Evaluation of applicants' qualifications and prior experience?
4. Personal interviews?
5. Verifying references?
6. Bonding procedures?
7. Final review and approval by management?
8. Documentation of the process?
f. Are pertinent federal, state, and local equal employment opportunity regulations adhered to?

C. Training and Development
1. What is the nature and scope of training programs?
2. To what extent do other activity line and staff managers participate:
a. by demonstrating support for the program?
b. by actually participating in the instruction and training?
3. Are activity organizational components satisfied with the training being provided? If not, why not?
4. Are personnel being trained satisfied with the training experience? If not, why not?

5. Does the activity have an orientation program for new employees? If so, does the program include:
   a. a general description of the program and how the new employee relates to the total program?
   b. an adequate description of job specifications?
   c. a description of administrative requirements (work hours, timekeeping procedures, etc.)?
   d. formal training if required?
6. Does the activity follow up on the performances of new employees to determine if they are achieving job standards?

5. Current Administration of Personnel Activities
   A. Job Analysis and Evaluation
      1. Review and appraise the design of the currently existing approach to job analysis and evaluation.
         a. how adequate are the criteria used?
         b. are weighting factors reasonable?
         c. is the number of classifications adequate?
      2. Are adequate specifications developed for individual jobs?
      3. Are the evaluations of individual jobs adequately made on the basis of the existing criteria and weights?
      4. Are job evaluations periodically reexamined for changing conditions?
      5. Does the system differentiate between levels of responsibility and complexity of work?
      6. Does the classification system include:
         a. position descriptions?
         b. skill level analysis?
         c. performance requirements?
         d. salary ranges?
      7. Are job assignments consistent with the job descriptions?
   B. Performance Evaluation
      1. Do adequate review forms exist for use at the several levels of organizational responsibility?
      2. Are policies and procedures reasonably adequate?
         a. are reviews required periodically?
         b. are reviews discussed with and approved by the next level of supervisory responsibility?
         c. is there adequate evidence of the communication of review results to the affected subordinate?
         d. are subordinates satisfied with the adequacy of the reviews being made by their superiors?
         e. is there reasonable evidence that the reviews lead to specific developmental action on the part of the subordinate?

3. Does the personnel department monitor and follow up on:
   a. absences?
   b. excessive time off?
   c. chronic lateness?
   d. failure to work a full day?
   e. actual or expected vacancies?

C. Employee Records and Reports
   1. Are employee records adequate in terms of design, and are they efficiently maintained?
   2. Are individual personnel files kept up to date and available for current reference?
   3. Are job action changes - transfers, promotions, merit increases, new hires, terminations, and the like - promptly processed?
   4. Review the NAFA employee retirement and/or insurance profram in effect.

D. Safety
   1. Is the scope of protective devices adequate? If not, in what areas is improvement needed?
   2. Does the entity have a formal safety reporting system?
   3. Are first-aid stations and other medical facilities available to employees?

6. Special Audit Tests
   A. Detailed Reviews of Individual Employee Benefit Programs. Over a period of time individual employee benefit programs should be subjected to detailed examination and review.
   B. Testing of Particular kinds of Processing. A particular type of job action - as, for example, getting a new hire into the records, or perhaps a change of job status - should be examined from the time of its inception to final completion. The focus here will be on types of problems encountered and time required for execution.

7. Overall Appraisal of Personnel Activities
   A. See standard Audit Guides, Exhibit 5-2.
   B. The people aspect of personnel activities broadens the scope of this overall appraisal.

Exhibit 5-5 (cont)

This audit guide was adapted from an audit guide presented in Modern Internal Auditing, by V. Z. Brink, J. A. Cashin, and H. Witt, New York: John Wiley & Sons, Inc., 1973, p. 320-324.

Additional material was adapted from the following books:

F. Pomeranz, A. J. Cancellieri, J. B. Stevens, and J. L. Savage, Auditing in the Public Sector, New York: Coopers and Lybrand, 1976, p. 139-147.

a. Basic Financial Control

This function can be further subdivided into the cash control function, the payable processes, and payrolls. It is important to realize, especially for this function, that a rule of reason must prevail in the establishment of controls. Because the function is often the source of abuse, the implementation of controls that are not cost-effective can be prevalent. Therefore, all controls in this function and others must continually be evaluated for their cost-benefit relationship. Exhibit 5-6 is this section's questionnaire.

(1) Cash Control

The handling of cash is important because it is the most transferable of assets and thus the most vulnerable to abuse. The objective of this segment in the financial function is to achieve a high level of protection and control. The auditor must therefore "critically appraise each situation and determine what degree of compromise from a control standpoint is justified because of other operational considerations. [Ref 5, p. 326] Consequently, this segment is concerned with the receiving of cash, cash handling and custody, cash disbursements, and other general aspects.

Control points for the receiving of cash consist of:

1. the accountability should be established at the earliest possible time.
2. the relief of internal accountabilities should be tied to the cash receipts to the extent practicable.
3. controls should be instituted to assure collection for services provided.

EXHIBIT 5-6

FISCAL ADMINISTRATION

BASIC FINANCIAL CONTROL

1. Introductory
   A. Reference should be made to the general discussion of audit guides, Exhibit 5-2.

2. Preparatory Activities
   A. See standard Audit Guides, Exhibit 5-2.
   B. The organizational group involved will be the accounting department or that part of the finance group which has the responsibility for basic financial control activities.

3. Organizational Factors.
   A. See standard Audit Guides, Exhibit 5-2.
   B. Matters of special interest in the review of policies will include:
      1. Scope of chart of accounts and description of individual accounts.
      2. Policies and procedures relating to these areas:
         a. cash processes: receipts, disbursements, custody, petty cash funds, branch funds, and administration of bank funds.
         b. payable processes: vouchering, internal review procedures, records, special payables, travel expenses, accruals, and notes payable.
         c. payrolls: preparation, review, and payment.
         d. receivable processes: maintenance of accounts, adjustments, bad debts, special receivables activities.
         e. general procedures: types of records, reports, and operational aspects.
         f. fraud: prevention and handling of actual developments.
      3. Coordinative arrangements with other activity entities.
      4. Handling of deviations.

4. Internal Operations
   A. Cash Processes
      1. Cash receipts
         a. Review the sources of cash and appraise both the possibilities of reducing or eliminating difficult to control conditions, and for better assuring effective establishment of accountabilities.

b. Determine that cash flows promptly and intact - without diversion for cash disbursements - directly to central depository control. Appraise the necessity of all deviations.
c. Are Sales and Collection Records maintained on a monthly basis for each cashier or cash register?
d. Is the sale transaction recorded in the cash register at the time of sale?
e. Vouch a sample of recorded cash receipts to a duplicate deposit slip, general ledger account, and bank statement.
f. Are the cash register totals checked by someone other than the cashier?
g. Are receipts deposited daily, intact, and without delay?
h. Does someone other than cashier or accounts receivable bookkeeper take the deposits to the bank?
i. Are the duties of the cashier entirely separate from recordkeeping for notes and accounts receivable? From general ledger recordkeeping?
j. Can the cashier obtain access to receivables records or monthly statements?
k. Are all other cash funds handled by someone other than the cashier?
l. Does any employee having custody of activity cash funds also have custory of non-activity cash funds?

2. Cash handling
   a. Are physical safeguards adequate at all stages?
   b. Is cash on hand-in all forms, at all levels, and for all purposes- at lowest possible level?
   c. Are cashiers instructed to stamp a restrictive endorsement immediately upon receipt of a customer check?
3. Cash disbursements
   a. Are petty cash funds utilized and operated on an imprest basis?
   b. Are standards adequate for documentary support? If not, why not? Appraise also the standards of review at the time of disbursement.
4. General
   a. Are all employees who handle or have any direct or indirect access to cash adequately bonded?
   b. Are independent work assignments in effect to the extent practicable, including the reconciliation of bank accounts?

c. Are records of accountability separately maintained?
d. Are cash funds periodically verified by independent parties?
e. Is a bank reconciliation performed monthly by someone who does not have cash custody or recordkeeping responsibility?

B. Receivable Processes
1. Are accounts receivable records maintained independently of cash receipts?
2. Are delinquent accounts reviewed by the NAFA Officer or someone designated other than the receivable bookkeeper?
3. Are disputed items and bad debts written off, properly controlled?

C. Payable Processes
1. General
a. Review and appraise the adequacy of the controls over the creation of all types of activity obligations. Is reasonable provision made for contingencies?
b. What procedures exist for the subsequent administration and liquidation of these obligations? Are they adequate?
2. Regular Accounts Payable
a. Review and appraise the procedures for the receipt, coordination, and ultimate matching of supporting documentary papers.
b. Are adequate control records maintained?
c. Review and appraise the procedures by which the payables are ultimately approved and linked with the check payments. Is proper provision made for the deduction of all existing counter claims?
d. Is the accounts payable ledger balanced periodically with the general ledger?
e. Are vendors' monthly statements checked against accounts payable or unpaid vouchers?
f. Are vendors' invoices registered immediately upon receipt?
g. Are all disbursements, excepting petty cash, made by check?
h. Are all check forms prenumbered and under control?
i. Are voided checks mutilated and retained for inspection?
j. Are check signers persons who have no access to accounting records, cash receipts, or bank reconciliations?

k. Is the numerical sequence of checks reviewed in the reconciliation process?
l. Are vouchers and other supporting documents reviewed by the check signer?
m. Are checks mailed directly by the signer and not returned to the accounts payable section for mailing?
n. Are the voucher and supporting documents stamped or impressed "paid" to prevent duplicate payment before being returned to accounts payable for filing?
o. Are interbank transfers under effective accounting control to prevent or detect kiting?

D. Payrolls
1. Are independently prepared personnel department records used properly as cross controls for the preparation of payrolls?
2. Review and appraise the effectiveness of the primary procedures and records by which the record of work is accumulated and validated.
3. Review and appraise the procedures by which payroll data are processed, authorized deductions made, payrolls finalized, and checks prepared.
4. Are the procedures for payment adequate to assure the release of checks to the proper individuals without the opportunity for diversion or modification?
5. Are payroll computations checked by someone other than the person who prepares the check?
6. Are the current tax withholding tables being used and tax payments being made when due?
7. Are there signed W-4 forms in file for each employee?
8. Are the time cards supporting pay earned, being approved by the appropriate supervisor?
9. If income and FICA tax withheld exceeds $200 in a calendar month, is the NAFA making the required monthly deposit?

E. Basic Accounting Activities
1. Are primary papers, journals, ledgers, auxiliary records, and reports adequately structured and administered in connection with the various accounting activities, and in a collective sense?
2. Review and appraise the operational effectiveness of the basic accounting activities - again in connection with particular financial processes and in total - as to:
a. distribution of work assignments
b. competence of personnel
c. utilization of personnel
d. effectiveness of coordination and support of other activity entities.
e. reasonableness of decentralization.

3. Evaluate the basic accounting activities, as to:
   a. cost of operation.
   b. error experience.
   c. fraud experience.
   d. orderliness of operations.
   e. recipients view as to service received.
4. Is written authorization for a petty cash fund on file?
5. Does the petty cash on hand plus receipts for disbursements equal the amount of the fund authorization?
6. Do the expenditures vouchers for the petty cash fund reflect authorized purchases?
7. Is merchandise intended for resale purchased from the petty cash fund?
8. Is written authorization for the charge funds on file?
9. Are the amounts of the change funds reasonable?
10. Are receipts being obtained when change funds are issued to cashiers?
11. Are proper physical safeguards and facilities employed to protect change funds?
12. Is written authorization for check cashing funds on file?

F. Fraud
   1. Appraise the extent to which the activity climate is attuned to fraud prevention rather than fraud detection.
   2. Are fraud potentials adequately studied both to prevent fraud and to protect individuals from excessive temptation?
   3. Are fraud developments systematically handled and also used as a basis for study of where procedures should be strengthened?

5. Special Audit Tests
Audit tests of policies and procedures may also include a certain amount of test verification of cash funds, receivable balances, payable balances, payroll authenticity, and the like. In addition, more extensive verification is frequently made of complete sectors of these assets and liabilities.

6. Overall Appraisal of Basic Financial Control Activities
A. See standard Audit Guides, Exhibit 5-2.

Exhibit 5-6 (cont)

FINANCIAL MANAGEMENT ACTIVITIES

1. Introductory
   A. Reference should be made to the general discussion of audit guides, Exhibit 5-2.

2. Preparatory Activities
   A. See standard Audit Guides, Exhibit 5-2.
   B. To a considerable extent the individual financial management areas will be handled as separate reviews.

3. Organizational Factors
   A. See standard Audit Guides, Exhibit 5-2.
   B. These organizational factors need to be adjusted to the particular sub-area being reviewed.
   C. Matters of special interest in the review of finance policies will include:
      1. accounting policy
      2. financial reports
      3. profit analysis
      4. cash management
      5. budgets
      6. profit plans
      7. capital expenditures
      8. supplying capital needs
      9. insurance
      10. pricing
      11. handling of policy deviations.

4. Activities Pertaining to Current Operations
   A. Accounting Policy
      1. Review and appraise the manner in which major accounting policies are developed, including depth of study and adequacy of coordination.
      2. Appraise the adequacy of the scope of existing policies, including those applicable to:
         a. product costing
         b. capital and revenue expenditures
         c. depreciation
         d. deferments of expense
         e. accruals of expense
         f. creation of reserves
   B. Report Analysis
      1. Review and appraise the total group of financial reports regularly issued, with particular reference to:
         a. focus on user needs
         b. ease of interpretation and use
         c. respect for individual manager responsibilities

d. quality of analysis
e. adequacy of attention to the future

2. Review the adequacy of analysis in the interpretation of financial reports.

C. Profit Analysis

1. Review and appraise the existing program for profit analysis.
2. Are adequate efforts made to recognize the limitations of profit analysis and to provide supplementary data?
3. Are flexible budgets used to the extent practicable?
4. Are incremental types of analysis utilized for guidance to management?
5. Is the total effort adequate, in the way of developing various types of profit analysis?

D. Cash Management

1. Is the importance of the cash management activity adequately recognized in terms of assigned responsibilities and quality of personnel?
2. Are there written guidelines outlining the objectives, policies, standards, and procedures for the cash management function?
3. Does the cash management function interact with other operating departments with respect to
   a. consideration of unforeseen cash requirements?
   b. normal receipt/disbursement of funds?
   c. approved collection/disbursement locations?
4. What steps have been taken to increase the availability of cash? Are they adequate?
5. Have cash flows been studied for maximum possibilities of regularization?
6. Is a cash budget regularly prepared and released to all interested parties?
7. How effective is the program for the investment of surplus cash?
8. Does the activity have appropriate charges for the cost of redepositing and reprocessing checks returned for insufficient funds.
9. Are bank deposits made on a daily bases?
10. Does the activity act in a timely manner to reconcile and settle discrepancies between amounts invoiced?
11. Does the activity use lock boxes for cash remittances?
    a. If so, are banks which receive lock box deposits required to forward deposit slips on a timely basis?
12. Has the activity compared the cost of managing the cash functions (payroll, etc.) in-house with the cost of having a bank perform such functions?

13. Are major disbursements deferred until the latest possible date?
14. Are cash discounts taken?
15. Are cash withdrawals avoided on Fridays as a means of gaining week-end interest?
16. If imprest accounts are used, is their number and balance limited?
17. Are written specifications maintained for banking services?
18. Does the activity prepare long-term forecasts of cash requirements by functional activity?
19. Does the forecast list the significant sources and uses of funds, taking into consideration changes in working capital?
20. Does the entity use a short-term forecast in determining day-to-day needs?
21. Is actual cash flow compared to forecast?
22. Has the activity developed formal directives regarding investment of funds?
23. If so:
    a. Are specific responsibilities delineated?
    b. Are specific procedures outlined?
24. Does the activity, by means of management reports or other such data, have an accurate idea of cash available for investment at any given time?
25. Does the activity perform periodic analyses of the yield obtained on available cash balances?
26. Do cash investments appear to be yielding a reasonable return?

5. The Planning Role
   A. The Annual Budget
      1. Has top management established and provided adequate backing for a budgetary program? Appraise whatever is being done of an annual planning nature?
      2. Is the responsibility for coordinating the development and later administering the budget placed at an adequate organization level?
      3. Is the organizational structure reasonably supportive of an effective budget program?
      4. Is the planning aspect of the budget adequately emphasized?
      5. Are there adequate procedures covering the manner in which budgets should be developed by the individual organizational components?
      6. Does the finance group provide adequate assistance through providing historical performance data, explaining procedures, and providing any other needed experience?

Exhibit 5-6 (cont)

7. Are the budget data developed along the lines of accounting reports, so that budgetary performance can be periodically measured and evaluated?
8. Are individual budgets as developed accepted by the respective managers as their own commitments and plans?
9. Are existing gaps reconciled on a mutually satisfactory basis?
10. Review and appraise the extent to which interim performance reports are used for management analysis. What evidence is there of resulting corrective action?
11. Is a budget calendar used?
12. If so, does the calendar?
    a. detail the completion dates for each phase of budgeting process?
    b. identify the organizational units involved in each phase of the process?
    c. permit time for management review at each organizational level?
    d. is the calendar based on prior experience modified for anticipated events?
    e. does the NAFA Officer monitor the budgeting process to insure that each step is accomplished in a timely manner?
    f. is the budget calendar flexible enough to permit consideration of unforeseen events?
    g. is the budget prepared in accordance with each fund's method of accounting?
13. Are estimates of revenue developed before the budget is formulated?
14. Does the activity have adequate procedures for identifying new sources of revenue?
15. Are the revenue estimates supported by detailed analysis?
16. Do revenue estimates give consideration to:
    a. actual revenues of prior years?
    b. reimbursement of certain expenditures?
17. Are management's assumptions concerning significant increases or decreases in revenue realistic?
18. Have those assumptions given consideration to:
    a. new sources of revenue that will be effective in the new year?
    b. changes in policy or conditions that may affect revenue items?
    c. the effect of pending legislation?
    d. the effect of economic conditions?

19. Are instructional packages sent to all departments in the initial stage of developing the expenditure budget?
20. Do these instructional packages include:
    a. the budget calendar?
    b. an executive statement concerning goals, policies, and expectations for the upcoming budget period?
    c. instructions for completing the budget forms, including comments on required documentation?
    d. analysis of the previous year's activities?
21. Do the executive policy statement and related documents included in the budget package provide:
    a. a translation of broad goals and policies into detailed requirements for the various departments?
    b. positive goals rather than negative ones?
    c. measurement criteria?
    d. the general level of revenue and expenditures for the projected budget period?
    e. estimates of expected cost reductions for the year by department?
    f. organizational plans for new, improved, or expanded services?
    g. comments as to the impact of economic conditions on services and programs?
22. Do the department budgets include goals and objectives in line with those in the policy statement?
23. Do the policy statements indicate how the goals and objectives should be measured?
24. Are the department programs and services consistent with these goals and objectives?
25. Is department workload data compiled and used to produce and support the budget request?
26. Are the budgets and supporting data received no later than the data designated in the budget calendar?

B. The Profit Plan
1. Apply the same guides as listed under the annual budget to the review of the profit plan activity.
2. Is the profit plan properly tied into the annual budget?
3. Review and appraise the adequacy with which new profit plans are reconciled with previous profit plans.

Exhibit 5-6 (cont)

6. Planning and Control of Capital Expenditures
   A. Capital Expenditure Budget
      1. Is a capital expenditures budget prepared? If not, appraise the extent of the existing need.
   B. Financial Evaluation of Capital Projects
      1. To what extent are methods used which adjust for the different time value of money?
7. Pricing
   A. Development of Pricing Policy
      1. What is the procedure for developing pricing policy? Does the finance department participate in a reasonable manner?
      2. Review and appraise the manner in which cost and revenue estimates supporting pricing action are determined.
      3. Is the coordination between the marketing and finance groups adequate?
   B. Operational Control
      1. Review and appraise the procedures by which price lists are developed and distributed.
      2. How adequate are the efforts to determine the propriety of prices actually used?
      3. Are procedures for the control of deviations adequate?
8. Overall Appraisal of Financial Management Activities.
   A. See standard Audit Guide, Exhibit 5-2.
   B. The overall appraisal can be made separately for each financial management sub-area, and also for the area as a whole.

This audit guide was adapted from an audit guide presented in Modern Internal Auditing, by V. Z. Brink, J. A. Cashin, and H. Witt, New York: John Wiley & Sons, Inc., 1973, p. 359-363 and p. 401-405.

Additional material was adapted from the following books:

F. Pomeranz, A. J. Cancellieri, J. B. Stevens, and J. L. Savage, Auditing in the Public Sector, New York: Coopers & Lybrans, 1976, p. 123-129, and p. 153-159.

J. C. Robertson, Auditing, Dallas, TX: Business Publications, Inc., 1979, p. 396, 400, 411, 435, 439

4. the outside party should be utilized where possible, as a further control.
5. consolidation of cash receiving points.
6. cash receipts should be separated from cash disbursements.
7. cash receipts to be channeled intact and promptly to the central cash depositories.
8. accountabilities should be properly established for all transfers.
9. records covering accountabilities should be independently operated. [Ref 5, p. 327-328]

Control points for cash handling and custody are:

1. physical safeguards should be adequate.
2. adequacy of insurance coverage.
3. cash on hand should be kept at minimum levels.
4. earning potentials should be realized to the extent practicable. [Ref 5, p. 329]

Control points for cash disbursements consist of:

1. separation of the disbursement function.
2. adequacy of documentation for liquidation of payables.
3. use of petty cash funds.
4. use of branch imprest funds.
5. the control over check signatures.
6. designation of payee of checks.
7. maximum separation of duties and responsibilities. [Ref 5, p. 329-331]

Control points for other general aspects of the cash management process consist of:

1. bonding of employees.
2. maximum exploitation of mechanical aids.
3. keeping records up-to-date and prompt reporting.
4. independent reconciliation of bank accounts. [Ref 5, p. 331-332]

(2) Accounts Payable

The accounts payable function of the activity handles organizational expenditures for products, services, equipment, and salaries and wages. The payable process is

concerned with the recognition of these obligations and the control and processing of them. Although the payable process does merge with the cash disbursement function previously mentioned, this section:

> . . .is concerned with the promptness and accuracy with which such obligations are formally recognized, the legitimacy and propriety of these obligations, and the procedures by which the stage is set for the final liquidation. [Ref 5, p. 339]

The control points for the accounts payable section consist of:

1. the reasonableness of the expenditures.
2. the reasonableness of the quantity purchased.
3. the correctness of the price and terms.
4. the correctness of the value received.
5. the adequacy of the approvals and supporting evidence.
6. the coordination and control of incoming papers.
7. the implementation of proper accounting entries.
8. the planning for payment dates.
9. final assembly and matching of supporting documents.
10. deduction of counter claims.
11. preparation of the check.
12. final review and release. [Ref 5, p. 340]

A key point in the control of payables is that processing responsibilities be appropriately separated in order to achieve individual responsibility for the processing and the implementation of cross-checking procedures.

(3) Payroll

The payroll function is concerned with expenditures for salaries and wages of employees. Because most NAFA operations are labor intensive, personnel expenses can sometimes be the largest controllable expense of the activity. [Ref 26, encl. 2] Payroll operations are directly related to

personnel functions and thus intimately involved with personnel and personnel problems. Consequently, the payroll function has numerous legal considerations such as minimum wage legislation, social security, and unemployment compensation that the auditor must be cognizant of.

The control points for the payroll function consist of:

1. accumulation of work evidence.
2. application of rates.
3. accounting distributions.
4. application of deductions.
5. determination of net pay. [Ref 5, p. 347-348]

The physical payment of the payroll should be subject to the same control as any other cash disbursement of the payable function. It is important that the preparation of the payroll be entirely separated from the segment responsible for the preparation or creation of the payroll records to minimize fraud.

(4) Auditor's Role

The auditors interest in the basic financial control process consists of the prevention of fraud and in any improvements in the processing of transactions. The factors affecting such items as budget preparation and cash flows are considered in the next section, financial management.

b. Financial Management

This section is concerned with the liquidity of the activity, the management of capital resources, the coordination of various segments of the activity for maximum

profitability and cash management. Exhibit 5-6 is this section's questionnaire.

Financial management can be sub-divided into two basic categories: current operations, and the planning role in financial management. Current operations is concerned with major accounting policies, profit analysis and cash management. The planning role is concerned with the credit policies of the activity, operational and product costing, capital versus revenue expenditures, depreciation rates, deferment and accrual of various expenses, accrual and deferment of income and the providing of capital reserves. [Ref 5, p. 366] In all of these particular situations, the auditor is concerned with the reasonableness of any policies or procedures in terms of both general accepted accounting principles and of any possible improvements that could be implemented.

(1) Current Operations

The general objective of profit analysis is the acquiring of additional information as to the trend of current operations, the identification of causes of any changes in trends, the comparison of actual accomplishments with a pre-determined standard, and an analysis of various alternative actions. There are two basic types of profit analysis, volume-cost profit analysis, and incremental profit analysis.

Volume-cost profit analysis requires the separation of costs into fixed and variable cost classifications and the projections of these costs at varying levels of sales volume

to obtain the resultant profit, including the breakeven point of the activity. The drawbacks to this method are the difficulty in classifying costs as either fixed or variable and the variability of product mixes and prices over different levels of sales volume.

Incremental profit analysis is concerned with the additional revenues that will be generated when additional costs are incurred. The margin by which the additional revenue exceed the additional costs is an indication of the advisability of the proposed change. This methods primary drawback is the estimation of the individual revenues and associated costs for the analysis.

Cash management is the focal point of the management of working capital. It involves the most efficient utilization of cash assets after considering the cash required for daily operations. Cash management involves the investment of surplus cash to maximize earnings and to allow for a regular cash flow to minimize any potential disruptions of operations.

The two major control points of cash management are concerned with the prompt transfer of cash balances to insure that funds in excess of any minimum balances are invested, and with the control of disbursements to insure that payments are met in a timely manner.

A key point in controlling cash flow is the development of a cash budget which identifies and summarizes the sources and flows of cash. When this budget is analyzed,

alternative courses of action can be identified to eliminate any potential problems.

The investment of surplus cash must consider such factors as the available liquidity, rate of return, and security of the investment. Professional counsel should be obtained if the amount of surplus funds to be invested is substantial.

(2) Planning Role of Financial Management

The second section of the financial management area concerns the planning function of the activity. While Commandant Instruction 7110.8 provides the framework for the planning and budgeting function of the various activities, the following guidelines are provided to supplement and to provide additional guidance for the auditor in the consideration of this function.

The primary purpose of the budgetary process is the achievement of better planning for current operations. If properly developed, the budget provides managers with an opportunity to "think thoughtfully and analytically about the effectiveness of the operations for which they are responsible, and to then develop plans for improving the operational results." [Ref 5, p. 373]

> An annual budget should be adopted by every governmental unit, whether required by law or not, and the accounting system should provide budgetary control over general governmental revenues and expenditures. [Ref 3, p. 102]

Budgeting basically consists of two processes: the formulation of the budget and the execution of the budget. The budget formulation process should be formalized through

established policies and procedures. These policies and procedures should outline management's analysis of current operations, future operations, and any other considerations that should be considered in the formulation of the budget. The execution of the budget is facilitated through the use of responsibility centers and the evaluation of activity performance.

The auditor's concern in the budgetary process is with the applicability of existing policies and procedures and with any improvements which might be made in the current system. The auditor's analysis should include the scope of instructions issued, timing restrictions, and coordination of the budget, and the final review and approval of budgetary plans. [Ref 5, p. 379] The auditor should also be concerned with the methods of budget implementation and evaluation that are in effect. Because the budget is a useful tool of managerial control, it is important for the auditor to adequately consider the entire budgetary process of the activity since it is in this area that significant improvements can be made.

E. REPORT

The audit report is the primary means for the auditor to communicate any findings or recommendations to the organization. Through it management decides the merits of recommendations, becomes cognizant of any deficiencies in the activity, and evaluates the merits of the audit program and the auditors work.

Although the report on an operational audit is not the ultimate objective of the audit as it is in an external audit by an independent auditor, [Ref 12, p. 39] it is the auditors major opportunity to alert management to potential problems and improvements in operations. The most important aspect of the report therefore, is the communication of audit results to management. Emphasizing the aspect of communication, the author recommends the following guidelines for the report.

1. GAO General Standards

The general standards of the GAO for reports mentioned in Chapter II provide the basis for an effective report. Although the auditors opinion regarding the "economy" and "efficiency" of an activity are perhaps irrelevant due to the relative nature of the terms as previously mentioned, an opinion of the auditor relating to these terms based on the auditors experience and knowledge can provide management with an insight to the activity. The subjective criteria outlined in the third reporting standard provide an appropriate guide to the auditor in the development of the report. These standards parallel those developed by the American Institute of Certified Public Accountants (AICPA), and are the model for reports in the public sector. Although they provide only qualitative guidelines, failure to incorporate them into a report can diminish the communication aspect of the report.

2. Nature of the Audit

Although the procedures for an operational audit are similar to those for a financial compliance audit, the constructive nature of an operational audit significantly differs from that of a financial audit. Consequently, the audit report should clearly indicate that it is an operational audit rather than a financial one. If the two types of audit are performed in conjunction, either a separate report should be issued for each audit or a single report submitted with the aspects of each respective audit identified separately. Separating the two reports is necessary because the different natures of the two audits could conceivably require review by different segments of management where the combined reports would not be appropriate.

3. Scope

The scope of the audit should be fully described in the report. The time period covered by the audit should be included in the report as well as a statement that the audit was conducted in accordance with standards promulgated by the Comptroller General. The scope should include a concise listing of what was done in the audit, the reasons for conducting the audit in such a manner, and any major problems encountered in the audit. Users of the report must be aware of the extent of the audit in order to formulate valid decisions concerning the results of the audit. By clearly defining the scope of the audit, the auditor can insure that misleading conclusions or inappropriate assumptions are not developed by management.

4. Findings/Results

In the findings section of the audit report, the auditor should summarize all the results of the audit work. All uneconomical and inefficient practices should be identified and if possible, the technique of dollarization should be applied.

> Basically, this technique enables a presentation of the cost of resources wasted through failure to adhere to a preferred practice. Dollarization also serves to quantify in dollar terms the magnitude of potential opportunities and/or alternatives. [Ref 3, p. 22]

The criteria used for determining the deficiencies should also be identified. The auditor may also have identified some practices which are questionable even though there are no clear identifiable criteria available. These practices should be presented by the auditor even if the auditee disagrees since it is the responsibility of management to determine the validity of any observations.

5. Recommendations

This section of the report should indicate the auditors opinion as to what actions are necessary to rectify any previously noted deficiencies. The recommendations should be outlined in sufficient detail to allow management to develop a comprehensive plan for implementing the suggestions. The recommendations should include that individual responsible for implementing the corrective action. The auditor should also indicate those areas of the activity where further study is warranted and the reasons for such study. If possible, the

auditor should indicate the scope of any future recommended audits.

6. Comments

This section should include any reactions or comments of the auditee regarding the manner in which the audit was conducted, any findings, and any recommendations of the auditor. It should specifically contain any points of concurrence and non-concurrence between the auditor and auditee. The auditor should also indicate in this section any change in procedures that the auditee has either taken, planned or contemplated as a result of the audit.

7. Report Distribution

Copies of the audit report should, as a minimum, be submitted to the auditee, and to the office that requested the audit. The report should be submitted as soon as possible after completion of the audit. Depending on the nature of the findings and recommendations, the report should be submitted to the cognizant authority of the activity.

F. SUMMARY

This chapter has described factors to be considered when developing or implementing established guidelines for audits. The chapter then presented the author's recommended guidelines for each phase of the model presented in Chapter IV, which are the defining of objectives, survey and planning, review, and reporting phases. The review phase was limited to guidelines for the procurement, property management, personnel, and financial management segements of Coast Guard NAFA.

The next chapter describes a brief field test of the model at the U. S. Coast Guard Academy NAFA and an analysis of the results of the field test.

VI. FIELD TEST OF THE MODEL

In order to determine the feasibility of the model developed in Chapter IV, it was briefly field tested at the U.S. Coast Guard Academy Non-appropriated Fund Activity (NAFA), on June 30, 1980. Due to time constraits, the application was limited to interviews with LT M. CRYE, USCG, and R. COLLINS, the NAFA officer and head accountant, respectively. In addition, management reports were examined as a means of determining the availability of current information on the operations of the NAFA. The first section describes the level of operations of the Coast Guard Academy NAFA and the organization of the activity. The second section is concerned with the actual application of the model. It describes various factors dealing with implementing the model that were revealed during the interviews. Each portion of the model is considered separately with the primary emphasis being given to the review portion of the model. The chapter concludes with a brief summary outlining considerations which were derived from the application which should be accounted for while applying the model.

A. OPERATIONS AND ORGANIZATION OF U.S. COAST GUARD ACADEMY NAFA

1. Level of Operations

The NAFA at the U.S. Coast Guard Academy has annual gross sales of approximately 4.5 million dollars, making it the sixth largest NAFA in terms of gross sales. As previously

mentioned in Chapter IV, it is composed of fourteen separate activities and employs approximately one hundred and sixty individuals. It has net assets valued at approximately $450,000 and plans future expansions costing an estimated $80,000. As previously indicated in Chapter IV, its projected sales for FY 80 is 5.41 million dollars.

B. ORGANIZATION

The NAFA officer is under the management of the comptroller of the U.S. Coast Guard Academy, who in turn reports to the Academy's Superintendant. In addition, the NAFA officer must comply with standards and procedures promulgated by the centralized NAFA branch located at Coast Guard Headquarters in Washington, D.C.

The internal organization is based on the fourteen different activities. Each of these activities has a manager who reports directly to the NAFA officer. The staff elements such as purchasing, personnel, etc., support the fourteen activities and are also directly under the NAFA officer.

The NAFA officer is charged with coordinating the efforts of the various activities and with the responsibility for any major decisions. In order to control the wide ranging activities, a management by exception technique is utilized based on quarterly reports.

B. APPLICATION OF THE MODEL

1. Definition of Objectives

Because this field test of the model was concerned primarily with testing the feasibility of the model and due to the time constraints, a complete application of the model was not done. However, during the discussion with the NAFA officer and accountant, areas of the operation with which the two individuals were concerned were revealed.

Concern was expressed about the survey procedures of the activity and the cost-benefit relationship of a rental data processing service. In an actual audit, the audit objectives would be directed at resolving any problems in these areas. Since a management by exception technique is used at the activity, an audit could be directed at resolving problems in the indicated areas.

The time constraints of an audit were also discussed at this time. Because an audit can be a potentially disruptive process on an activity's operations, an audit of all the areas covered in Chapter V was considered by the individuals as being too disruptive on an activity. It was estimated that each area would require two auditors, two to three weeks to complete. The objectives of the audit must therefore consider not only the audit resources available but the potential effect of the audit process on the activity.

2. Initial Survey

This portion of the field test was accomplished through the aforementioned interviews and through an examination of management reports.

The interview process gave a broad overview of the organizational structure, level of operations, problem areas, and future plans of the activity. A discussion with each activity manager could have provided familiarity with that activity. In addition, interviews with the heads of the staff functions could have familiarized the auditor with those functions' procedures.

There were two management reports that were examined. The first report was manually prepared on a quarterly basis and the second report was computer generated on a weekly basis.

The first report was prepared by activity and showed the cumulative amount of sales and expenses for the current fiscal period, the budgeted amounts for the same period, and the actual amounts for the previous year for the corresponding period. This report would allow an anlysis of the trend of operations for the activity and the extent of its operations.

The second, computer generated, report showed the transactions of each cash register in all activities. This report was used to confirm the manually obtained transaction records from the cashiers. This report could be used as an indication of the activity levels of each register which in turn could familiarize the auditor with the relative levels of operations for each activity.

3. Review Phase

The review phase of the model was tested by conducting an extensive analysis of the questionnaires developed in Chapter V. Each question or procedure was discussed as to its applicability to Coast Guard NAFA, the implications of potential answers to the questions, and whether the question was clearly worded. Ambiguous or redundant questions were corrected or eliminated respectively. Each questionnaire was checked to insure that it was complete in itself so that it could be applied without refering to the questionnaires for other areas.

In addition to an examination of the existing questionnaires, additions to the questionnaires were also discussed. Two areas for which recommended questions were required to be developed were concerned with data processing and the survey procedures of the activity.

Questions concerning data processing were added to the questionnaires that emphasized the benefits of a data processing system as opposed to its cost in comparison to a manual processing system. Because data processing has applications in various areas, the questionnaire for each area was examined for compatibility with a data processing sytem.

The questions concerning survey procedures required a more extensive treatment than was originally developed. These additional questions were included in the property management questionnaire. The questionnaires presented in

Chapter V include all additions, deletions, and corrections developed from the aforementioned questionnaire review.

Answers to the questionnaires showed that a further review into the following areas was warranted: data processing, survey procedures, protection of blank checks, personnel evaluations, and the development of an organization chart.

The assertion to be tested in data processing was whether the cost of renting the data processing equipment of $1000 a month was justified in terms of the benefit derived. The review procedures would consist of determining what the generated reports were used for.

The survey procedures for the activity appeared to be vague and there was some question as to whether they were being followed. The review procedures in this area would consist of tracing any survey reports to destruction reports and examining the procedures for any serious omissions.

Blank checks were kept in a room to which only five individuals had access, however, they were not kept in a secure place in the room. Preferred practice would require that the checks be kept in a secure safe to prevent their theft.

A potential problem in the completion of required personnel evaluations was also indicated during the questionnaire analysis. There appeared to be some misgivings on the part of management and the employees as to the benefit derived from completion of the forms. Review procedures would consist of trying to determine why the attitude was prevalent through such procedures

as interviewing employees and examining completed reports. A review of the use of the completed forms might also reveal the validity of the attitude.

The final area in which the auditor would be concerned dealt with the absence of an organization chart. Although position descriptions were on file, an organization chart provides an excellent visual reference outlining the relationships of individuals and activities to each other.

4. Report Phase

The report phase from the audit would be sent to the Comptroller of the Coast Guard Academy, the Superintendent of the Academy, and to the NAFA organization in Coast Guard Headquarters. The report would include comments from the activity managers, the heads of the various staff functions, and the NAFA officer.

The contents of the report would outline the results of the previously mentioned review procedures, the potential consequences of deficient findings, and the auditor's recommendations for correcting or improving any observed deficiencies or procedures. This section would mention the absence of the organization chart and briefly explain why such a chart is recommended.

The report would also contain the auditor's opinions as to the financial condition of the activity. It was the author's opinion, based on the limited review, that the NAFA at the Coast Guard Academy was well organized and effectively managed.

C. SUMMARY

This chapter has described a brief field test of the model developed in Chapter IV. The model was briefly applied at the NAFA at the U.S. Coast Guard Academy as a means of determining its applicability and correcting any problems or omissions in the questionnaires developed in Chapter V. Although time constraints precluded a more extensive test, it was determined that the model is feasible and would contribute to improved management of NAFA.

The next chapter describes various implementation problems and factors that should be considered in instituting a Coast Guard NAFA operational audit program.

VII. IMPLEMENTATION

This chapter describes the author's recommendations and opinions concerning an implementation of the model and guidelines developed in Chapter IV and Chapter V, and experience from the partial field test of the model described in Chapter VI.

The first section is concerned with the auditor's qualifications and the author's opinion as to the minimum auditor requirements. The second section describes considerations to be accounted for while planning an operational audit, including the establishment of policy relating to the audits.

The third section describes the use of audit manuals, their contents, and their development. The final section describes the various ways in which an internal audit function can be organized and includes the author's opinion as to the most advantageous audit organization for a Coast Guard Non-appropriated Fund Activity's (NAFA) audit program.

The chapter concludes with a brief summary of the study and with the author's recommendations of areas for further study.

A. AUDITOR QUALIFICATIONS

A key factor in any implementation program for an operational audit is the level of auditor competence or auditor qualifications. Because the success of an operational audit program is highly dependent on the auditor conducting

the audit, his or her abilities dictate the scope and potential benefits or any operational audit program. Unless the auditor has the requisite basic education and other traits previously mentioned in Chapter II, very few operational audit programs, no matter how well planned and conceived, can succeed. The following sections consider the author's opinions and recommendations for an operational audit program in Coast Guard NAFA.

While the educational recommendations mentioned in Chapter II are desirable for an auditor, it is recognized that there are probably few Coast Guard personnel with all of these educational credentials. However, a satisfactory number of qualified personnel may be found that possess some of the following basic educational credentials.

Of utmost importance for an auditor is a basic understanding of financial accounting systems. Because a functioning accounting system is an integral part of any economical and efficient activity, the auditor must be familiar with the basic underlying principles which should be present in such a system.

The auditor should also understand the underlying principles of an effective internal control system. The auditor must be aware of basic internal control procedures so that deficiencies in current methods can be noted and appropriate recommendations made for implementing more effective procedures.

Since it is conceivable that the success or failure of an audit could depend on how the auditor relates to personnel at the activity, the auditor should be cognizant of various management techniques and of the various advantages and disadvantages of their application. In addition, the auditor must be able to recognize any managerial shortcomings and make recommendations as to how management techniques at the activity could be improved.

The experience of the auditor can also be an important contributing factor to the success of the audit. Familiarization with basic NAFA operations can be beneficial to the auditor since such experience allows the auditor to devote more efforts toward improving operations rather than on becoming familiar with the basics of the activities operations. The auditor should also be familiar with the political aspects of the Coast Guard organizational structure. Developing recommendations for improvements requires that the auditor be cognizant of potential problems in getting the recommendations accepted by both the activity and the cognizant authority of the activity.

Because the actual porcedures of an operational audit are similar to those of a financial compliance audit, prior audit experience can assist the auditor in determining what compliance and substantive tests are appropriate for the assertion in question. Prior audit experience in coping with audit problems can also provide the auditor with insights in overcoming difficulties in the audit.

While the educational and experience qualifications for an auditor may seem onerous, it should be recognized that they apply to the entire audit team collectively. The selection of the audit team should therefore be directed toward the development of a team that will collectively possess all or most of the requisite qualifications. The selection of the audit team must revolve around selecting individuals that not only collectively possess the basic qualifications but who are also capable of coordinating their efforts during the audit.

B. PLANNING

The nature of planning for an operational audit program consists of four stages: formulating objectives, formulating strategy, the developing of supporting policies and procedures, and the budgeting of time.

In planning an operational audit, it is important for management to define the direction that it wishes the auditor to proceed during the audit. The following aspects should be considered in the formulation of these objectives:

1. The type of mangerial assistance - Management should attempt to establish what particular aspect of the activity that it wants the auditor to examine and what are some of the possible goals that it wishes to attain. The input of the NAFA officer is especially important in this stage.

2. The level of managerial assistance - This determination is concerned with what organizational level of the activity the auditor is to concentrate the examination on.

3. The degree of independence - Because the independence of the auditor is an integral part of the audit, management should clearly and concisely establish what areas of the activity the auditor is to have access to during the audit.

4. The resources to be provided - Management must identify the extent to which resources are to be made available to the auditor for the conducting of the audit.

5. Identification of the time periods - Management should identify what fiscal year or other time period the review is to cover. [Ref 5, p. 579]

Although the final audit program will be planned by the auditor, the objectives established by management can serve as a basic guide to the auditor throughout the examination.

The formulation of the audit's strategy is basically the planning relating to how the goals and objectives of the audit are to be attained. The formulation of strategy should include the consideration of the following aspects:

1. manner of organizing - This aspect concerns the actual organizing of the audit teams and the relative degree of independence which will be given to the individual members of the team.

2. manner of directing - This aspect is concerned with the issuing of directions to the team, providing leadership and the coordination of the individual team members efforts.

3. extent of formal auditing procedures - This aspect is concerned with the extent to which the audit team is required to follow established audit procedure and the degree of latitude allowed in their implementation.

4. manner of reporting - This aspect is concerned with the nature of the report to be submitted, its distribution, and the timing aspects of the report.

5. emphasis upon operational versus financial auditing - This strategy policy formulation is concerned with the relative emphasis that will be given to the two types of audits. The strategy should be established so that either a combination of the two audits will be conducted and whether or not special tests will be conducted for either audit.

6. level of aggressiveness - This is an overall strategy issue that is concerned with the attitude of the audit team, the standards that will be set as a criteria for evaluation, and the extent to which recommendations will be pursued. [Ref 5, p. 581]

The development of policy and/or established procedures should be based on the experiences from the initial operational audits. Because a defined policy can give consistency to an operational audit program, the author recommends that policy be developed based on the aggregate experiences of different audit teams from various activities. A coordination of effort between experienced audit teams and management can potentially result in proven beneficial policies.

Management and the audit teams should also work together in defining the relative degree of flexibility that should be allowed the individual audit teams in interpreting established policy. While too much flexibility can lead to inconsistency among the audit teams, too little flexibility can lead to a rigidly defined audit procedure which does not allow the audit team to exercise its judgment.

Although related to the allocation of resources for the audit, the importance of allowing enough time for an adequate job must be emphasized throughout the planning stage. Without ample time to conduct the audit, the potential benefits of an

operational audit program may not be realized. Since it is probable that the amount of time required for the audit will not be readily discernible until after the survey phase, it is important for management to budget the additional time for the audit team if the survey results so indicate. As management becomes more familiar with an ongoing operational audit program, time estimates may become more realistic which consequently will allow better planning for audits.

C. MANUALS

Audit manuals "describe the written policies, instructions, and review procedures developed for the guidance," [Ref 5, p. 315] of the audit team. Audit manuals serve two primary purposes: the communication of administrative policies and procedures and the communication of actual audit work that management requires for all audits.

Although an audit manual may lead to rigidity in the audit, if it is properly developed it can communicate to the auditor management's policies and establish those procedures which management has determined should be conducted during all audits. While the manual should possess enough detail to avoid being vague, it should nevertheless allow the auditor enough flexibility to exercise his or her professional judgment.

The auditing instructions in the manual may take the following form:

1. operational actions to be carried out.

2. specific audit determinations that are required to be confirmed.

3. individual auditing tests to be performed.

4. the asking of certain questions such as those presented in the Exhibits of Chapter V.

5. statements of sound practice that the auditor should use as criteria in determining the adequacy of internal control procedures.

6. statements of audit objectives that the auditor should rely upon in developing the audit program. [Ref 5, p. 618]

D. AUDIT ORGANIZATION

There are four basic approaches to the placement of any audit organization: organization by type of audit, organization according to activity served, organization according to the area served, and the use of a centralized headquarters audit organization. [Ref 5, p. 586]

Organizing the audit organization around the type of audit may be practical in a large organization where a certain degree of specialization is desirable, however, in an organization the size of the Coast Guard, it is not feasible.

An audit organization developed around the NAFA organization has been implemented in the Department of Defense. [Ref 27, p. 1-6] The degree of specialization possible in such an audit organization could potentially result in more economical and efficient audits, however the size of Coast Guard NAFA operations probably does not warrant the establishment of a separate audit organization for Coast Guard NAFA.

An audit organization developed around the area approach would assign a certain area to a particular audit team. Under the Coast Guard organizational structure, each District or Area would have their own NAFA audit organizations. While this organizational plan may have merit for large organizations, the size of the Coast Guard precludes the feasibility of a NAFA audit team centered on an Area or District basis.

The final approach to an audit organization is developed around a centralized staff situated at the headquarters level. This centralized staff could develop the necessary expertise and specialization for an effective and economical audit of Coast Guard NAFA.

Some of the basic functions which an adequate audit organization should handle are as follows:

1. Budget performance
2. Manpower assignments
3. Audit progress
4. Time reports
5. Job completion evaluations
6. Finalization of reports
7. Report processing and distribution
8. Report followup [Ref 5, p. 612-614]

Based on an initial evaluation, the centralized audit organization seems to be the most advantageous type of organization for Coast Guard NAFA, in the author's opinion.

E. CONCLUSION

This study has attempted to present standards and guidelines for an operational audit of Coast Guard NAFA and various aspects of implementing such a program. Throughout the study,

the importance of the auditor's role and especially of a constructive attitude on the part of the auditor has been stressed. The development of audit programs for various segments of the activities that incorporated aspects of both a financial compliance audit and an operational audit program was presented. While these programs cover the major segments of the activities, other programs for other segments of the activities remain to be developed.

Research in this area should consider the personnel resources available to the Coast Guard from which qualified auditors could be obtained. In addition, the feasibility of utilizing Department of Defense auditors should be examined as a potential means of implementing an operational audit program. While an initial recommendation was made concerning a potential audit organization,the issue requires further study. Further study is also required to establish appropriate management criteria.

Because Coast Guard NAFAs are an important part of morale and an integral part of military benefits, the development and implementation of an effective operational audit program could potentially result in benefits in excess of the financial costs of such a program. It is the intent of this study to provide the framework around which such a program can be developed.

APPENDIX A

APPENDIX F

GUIDELINES FOR AUDITING

COAST GUARD EXCHANGES

1. PURPOSE

To provide audit board members with guidelines for auditing Coast Guard Exchanges. These guidelines were developed by Commandant (GF) and should be used by audit boards performing exchange audits.

2. RESPONSIBILITY OF AUDIT BOARD MEMBERS

a. Audit board members should:

(1) familiarize themselves with the Manual for Non-appropriated Fund Activities and other official guidelines;

(2) test the validity of accounting transactions and the accuracy of accounting records;

(3) evaluate the effectiveness of operating controls (internal controls); and

(4) report to the commanding officer of the unit on the financial condition of the exchange and on the results of operations for the period audited, including constructive suggestions for improvement.

3. PREPARATION OF WORKING PAPERS

a. Effective auditing requires that working papers be prepared in an orderly manner showing information obtained, work performed and conclusions reached. These papers may consist of analyses, summaries, memorandums, correspondence, copies of reports, or charts relating to the audit. The working papers constitute the record of information obtained, the audit work performed, and the auditors' findings thereby forming the connecting link between the work performed and the audit report.

b. Each working paper should be identified as to the name of the unit or activity under audit, the subject matter of the worksheet, and the audit date. This is a matter of workmanship whereby each paper is enabled to stand on it's own feet. This information should be centered at the top of each worksheet. Also, each working paper should bear in the upper right hand corner the name of the auditor preparing it and the date of preparation.

c. Each working paper should:

(1) be prepared on paper of a uniform standard size;

(2) be neat and legible;

(3) have a purpose directly related to the audit, and

(4) show the source of information.

d. Audit working papers should be prepared to support various phases of the audit such as: (1) cash counts; (2) bank reconciliations, and (3) analyses of accounts and inventories. Working papers should also include the auditor's notes and comments on each audit phase.

e. Working papers should be retained for at least three years and should be made available for review by authorized persons.

4. AUDIT WORK PROGRAM

a. Cash on Hand

(1) Observe cash counts performed by cash custodians for each cash fund such as change funds and the petty cash fund.

(2) List cash counted on a separate work paper for each cash fund. Include bills, coins, checks, and other cash items such as money orders. Sign and date each cash count work paper and secure the signature of the custodian performing the count. Summarize cash count work papers using the following sample summary as a guide:

C. G. EXCHANGE

Summary of Cash on Hand

Cash on Hand:		
Undeposited Receipts - 31 August 1967		$ 790.50
Petty Cash Fund:		
Cash	$ 17.00	
Vouchers	3.00	20.00
Change Funds		
Activity A	$ 50.00	
Activity B	50.00	
Activity C	25.00	125.00
Total cash on hand (Shown on financial statement for August 1967)		$ 935.50

b. Petty Cash Fund

(1) Prepare a statement of accountability for the petty cash fund. Cash on hand plus petty cash vouchers supporting payments should equal the total petty cash fund authorization.

(2) Review petty cash vouchers to determine if they were properly approved.

(3) Determine if the fund is used only for small expense items not normally paid by checks.

c. Cash in Bank

(1) Obtain the latest bank statement and canceled checks for the period audited.

(2) Reconcile the balance on the bank statement with the check book balance and confirm the bank balance directly with the bank.

(3) Examine canceled checks for one week of the audit period and trace to Daily Exchange Journal or Purchase Journal - Check Register:

(a) compare checks drawn with accounting distribution;

(b) compare name of payee, amount, and date of check with Daily Exchange Journal or Purchase Journal - Check Register;

(c) compare first endorsements with name of payee; and

(d) investigate double endorsement where second endorsement is a person connected with the exchange.

(4) Determine if all checks are accounted for and if voided checks are marked "VOID" and retained.

(5) Determine if deposits in transit at end of the prior audit period were deposited promptly.

(6) Compare total receipts on Daily Exchange Journal or on Cash Receipts and Sales Journal with total deposits shown on bank statements and account for any differences.

(7) Compare total withdrawals on bank statements with total disbursements shown in Daily Exchange Journal or Purchase Journal - Check Register.

(8) Determine if cash receipts were deposited on a timely basis.

(9) Foot and crossfoot cash receipt and disbursement records for the audit period and trace totals to general ledger accounts.

(10) Determine if checking account is maintained in accordance with chapter A05.

d. Investments

(1) Observe counts of securities on hand and check the total with the balance shown on the general ledger account and Statement of Financial Condition. If the securities are not on hand, obtain confirmation from the depositary.

(2) Examine securities to determine if they are registered in the name of the exchange. If the secirities are cupon bonds, see that all unmatured coupons are attached. Also see that proceeds of matured cupons are reflected on the accounting records.

(3) Determine if investments are carried at the cost price.

(4) Determine that securities owned by the exchange are properly safeguarded.

(5) Determine if detailed records are maintained by the accounting office, showing the type of security, cost, date purchased and other pertinent data.

e. Other Assets

(1) Determine if adequate records are maintained for any Other Assets.

f. Net Worth

(1) Prepare a schedule showing the beginning and ending balances in the surplus and reserve accounts for the period audited to determine the:

(a) changes in the accounts;

(b) accuracy of transactions; and

(c) validity of adjustments made during the period.

(2) If the net worth is less than about half of the merchandise inventory value, identify the reasons for the difference if possible. Some exchanges will not neet this standard due to recent establishment, or for other reasons.

g. Observation of Inventory Taking

(1) Observe inventory taking procedures used by exchange inventory teams at all locations (activities). (Some time should be spent with each team.)

(2) Describe inventory taking procedures used by each inventory team and comment on deficiencies noted in your working papers.

(3) Verify the accuracy of extensions and footings on inventory sheets. (This audit step should be performed on a test basis.)

(4) On a test basis, determine if items included in the inventory were either paid for or accrued (an accounts payable established).

h. Accounts Receivable

(1) Prepare a schedule showing accounts receivable by age (current - not more than 30 days; 30-60 days; and over 60 days) and determine if:

(a) Action is being taken to identify and collect delinquent accounts (account over 30 days old) excluding accounts for which payments have been received, but not yet posted to the accounts;

(b) Accounts written off as bad debts were properly approved; and

(c) Overpayments of accounts are shown as liabilities on the financial statement.

i. Exchange Property Records

(1) Observe an inventory of exchange owned furnishings and equipment. Determine if the equipment is properly identified and if the locations of the items agree with the property records.

(2) Check physical counts with quantities recorded on the property records and investigate differences.

(3) Determine if a physical inventory was taken in connection with the last exhange audit.

(4) Account for items sold since the last physical inventory.

(5) Examine exchange property for worn out or obsolete equipment.

(6) Review property records to determine if the date of purchase, cost, location, and description of the property (including manufacturer's serial number) is recorded on the records.

(7) Determine if:

(a) property records are maintained on a current basis;

(b) purchases and dispositions were approved; and

(c) discrepancies betweeen the property records and physical inventories were investigated and adjustments approved.

j. Accounts Payable and Other Liabilities

(1) Prepare a list of accounts payable in the open accounts payable document file and compare the total dollar balance with the general ledger balance and Statement of Financial Condition. Differences should be analyzed and explained.

(2) Compare monthly statements from creditors with actual documents on file or with the invoice register (if maintained).

(3) Review several paid invoices to determine if they are fully supported and stamped or marked paid to prevent duplicate payments.

(4) Determine if the Government is being paid for the cost of utilities consumed. Prepare a schedule to show the amount paid for each utility.

(5) Determine if exchange expenditures for materials and services were proper charges to exchange funds and that appropriated funds were not used for exchange expenses.

(6) Determine if:

(a) detailed records of open accounts payable were reconciled with accounts payable balances:

(b) vendors' statements were compared with the supporting documents and the invoice register before payment was made;

(c) unpaid invoices were recorded as liabilities when the goods were received;

(d) provisions were made to accrue expenses incurred but not yet paid and if amounts accrued were proper charges,

(e) invoices were held in a file pending receipt and acceptance of materials or services; and

(f) accounts were settled promptly and if discounts offered by vendors were taken.

(7) Verify the accuracy of the liability accounts by referring to original documents such as vendors' invoices, payroll records, tax bills, contracts, state and Federal tax returns.

(8) Review expense accounts to determine if liabilities were established.

(9) Determine the reasons for not settling old accounts (60 days old or over).

(10) Test unpaid invoices for receipt and acceptance of goods or services. Also, test the accuracy of computations on invoices.

(11) Review invoices received for the first five days after the preparation of monthly financial statements to determine if they show any indication of receipt or acceptance prior to the statement preparation and if they shouould have been included as liabilities.

k. Sales

(1) Test the accuracy of daily transactions listed in the Daily Exchange Journal or Cash Receipts and Sales Journal for several days by tracing the entries to the Sales and Collection Records for each activity.

(2) Test the accuracy of the Sales and Collection Record (for the same period used in para. (1) above) by tracing the daily transactions listed to cash register tapes, credit sales, chits, or other supporting documents.

(3) Test the accuracy of the entries on the general ledger sales accounts and accounts receivable subsidiary records by tracing them to the Cash Receipts and Sales Journal (for the same period used in paras. (1) and (2) above).

(4) Compare total sales from month to month and determine the reason for large variations.

(5) Determine if daily cash overages and shortages were properly recorded.

(6) Compare gross profit percentages for each activity (as shown on line 12 of CG 4531) from month to month and determine the reason for large variations.

(7) Determine if the pricing policy established by the commanding officer of the unit is being adhered to.

(8) Determine if:

(a) price lists are conspicuously displayed or if all merchandise is individually marked;

(b) all sales are rung up on cash registers at the time of sale (this may be determined by observation);

(c) the exchange officer collects cash from cashiers at least daily or more often if the sales volume is large;

(d) cash sales receipts were compared with cash register readings when cash was collected from cashiers and if differences were recorded as overages or shortages;

(e) net profit from sales exceeds 15 per cent of total sales; and

(f) the exchange is following procedures established for identifying authorized patrons.

1. Purchases and Expenses

(1) Determine if:

(a) the exchange uses written, serially numbered purchase orders for purchases except petty cash purchases;

(b) purchase orders were approved by the exchange officer or other responsible officials; and

(c) verbal orders were confirmed by written confirmation purchase orders.

(2) Test invoices and review supporting documents for approval, receipt and acceptance. Also, test computations on invoices for accuracy.

(3) Review transactions for first five days of the month subsequent to audit period to determine if any purchases or expenses are applicable to the period under review.

(4) Determine if:

(a) purchase and expense transactions were accurately recorded in the Daily Exchange Journal or the Purchase Journal - Check Register;

(b) Purchase Journal - Check Register totals were accurately entered in the general ledger;

(c) all deliveries were inspected as to quantity and quality of merchandise by the exchange officer or other responsible official;

(d) the exchange officer spot checks deliveries received by others;

(e) if all items purchased for resale were authorized; and

(f) merchandise was purchased in quantities based on actual needs.

m. Taxes

(1) Obtain copies of tax forms prepared for the exchange, such as income taxes, social security, excise taxes, and other state and Federal taxes.

(2) Compare tax forms with supporting documents and test the accuracy of computations.

(3) Determine if deductions from employee wages were accurate and in agreement with applicable payroll deduction schedules. Also, verify the number of dependents claimed with supporting exemption certificates.

(4) Verify the accuracy of rates used to compute tax payments and determine if payments were made when due.

n. Other Audit Areas

(1) Determine if:

(a) insurance and bonding agreements provide adequate covering against potential losses;

(b) contributions to the Coast Guard Trust Fund and the District Morale Fund were made on a timely basis and accurately computed;

(c) security for cash and inventories was adequate; and

(d) required letters of designation were on file, such as letters designating exchange space and activities.

DEPARTMENT OF TRANSPORTATION
UNITED STATES COAST GUARD

Reply to
Commander (fbr)
Fifth Coast Guard District
Federal Building
431 Crawford Street
Portsmouth, VA 23705
Phone: (804) 393-9611

7500
10 February 1978

From: Audit Board
To: Commanding Officer, USCG Support Center, Portsmouth, Va

Subj: Independent Audit of Non-Appropriated Fund Activities; Submission of

Ref: (a) Manual for Non-Appropriated Fund Activities (CG-146)

1. As required by reference (a) the Audit Board report for the period 18 October 1977 to 31 January 1978 is submitted herewith. The examination was conducted in accordance with reference (a) and included such tests of the accounting records found to be on hand and such other audit procedures as were considered necessary under the circumstances.

2. At this writing the reports required by reference (a) have not all been completed nor do they all balance. The rough drafts were received and the following comments are offered relative to them and our examination:

A. Cash Management

1. Change and petty cash funds were verified and letters of authorization reviewed.

2. Cash books, sales journals and cash receipts did not reflect properly the transactions that occured during the period under review. Bank deposits were properly made but not in a timely manner.

3. Petty cash vouchers were reviewed and found to be properly approved and used. The change and petty cash funds were all maintained within the authorized limits prescribed except for the cashier's change fund. See enclosure (1). The overage noted of $722.61 was 145% above that authorized. This was due to two things:

a. Vending receipts not being deposited in a timely manner:

DATE RECEIVED	AMOUNT
18 Jan 78	$239.10
19 Jan 78	$207.15
30 Jan 78	$220.05
31 Jan 78	$ 38.86

b. Vending machine overages were received but not receipted for or entered into the records. (This amounted to $18.65 and was being used to make refunds to customers.) This was corrected during the audit.

1617 (5M) (REV. 8-69)

Subj: Independent Audit of Non-Appropriated Fund Activities; submission of

B. Cash in Bank

1. The bank statement was reconciled with the check book balance and the bank balance was confirmed directly with a bank officer. See enclosure (2). The additional verifications required by Appendix F, Section 4c of Reference (a) were performed and found to be correct, except as noted in A.3. above.

C. Accounts Receivable

1. In accordance with Section 4b, Appendix F of Reference (a) a schedule of accounts receivable was made. See enclosure (3). All verifications were made as required.

D. Inventory

1. Inventory taking procedures were observed with the exception of the vending and exchange warehouse inventories which were taken prior to the arrival of the audit team. These were spot checked during the audit and are believed to be accurate.

2. All inventories were taken by NAFA personnel. Deficiencies noted were:

a. In the exchange store, inventoried by three teams, an entire section had to be reverified because of numerous errors noted by the audit board and an inability to verify the inventory sheets.

b. The warehouse inventory was taken from the stock record cards by dollar amount. A line item inventory should be taken as was done for the other activities. This inventory was extremely hard to verify as there was no relationship to bins and shelves and the cards were in random order and not related to the placement of goods in the warehouse. It is recommended that the warehouse inventory be rearranged in a systematic manner. All bins and shelved should be numbered and labeled and the stock record cards kept in that same order and labeled accordingly. A standard warehouse system of bin/shelf numbering could be used to good effect. This would give future audit teams more confidence in their verifications.

c. Only minor discrepancies were noted in the Enlisted Club inventory and they were corrected.

Subj: Independent Audit of Non-Appropriated Fund Activities; submission of

d. The inventories for the CPO Mess Bar and Food Service were intermingled. One entire inventory page was found missing and subsequently recovered. In addition, numerous items were later found to have been left off of the inventory completely. It is believed this was corrected.

e. An accurate inventory is the primary base of all good audits and exchange reports. It is therefore recommended that an Inventory Verification Team be established, and be used to assist NAFA personnel each quarter and the Audit Board semi-annually. It is further recommended that this team consist of at least five members and that no inventory be considered valid unless a member of the team was present when the inventory taking commenced and during its compilation.

f. Inventory sheets were tested as to footings and extensions and no discrepancies noted.

g. Accounts payable at 31 January 1978 was $43,769.33 which was 36.10% of the total inventory of $121,230.70. This represents a 50% reduction in accounts payable from the prior period ended 17 October 1977.

E. Exchange Property Records

1. The exchange plant property records were not in a form available to audit due to the fact that the changeover to the new Plant Property System had not been completed.

F. Other Assets

1. Adequate records are maintained for other assets which are made up of only the advances to the Satellite Exchanges.

G. Accounts Payable and Other Liabilities

1. A listings of Accounts Payable was prepared as enclosure (4). In accordance with Section 4j of Appendix F of Reference (a) the additional verifications as required were performed and the following minor discrepancy was noted:

a. Invoices exceeded Accounts Payable vendor card balances by $457.33. This appears to be a posting error.

2. The schedule for utilities is included as enclosure (5).

(fbr)
7500
10 February 1978

Subj: Independent Audit of Non-Appropriated Fund Activities; submission of

H. Sales

1. Daily transactions were traced to the sales and cash journals and found to be made accurately but not in a timely manner as noted in paragraph A(3) of this report.

2. Sales were compared from month to month and no unusual variations were noted.

3. Daily cash overages and shortages were properly recorded with the exception of overages turned in by vending operators and concessionaires. This was reflected in the cashier's change fund and corrected during the audit.

4. Gross profit percentages for each activity were compared on a quarterly basis. No large variations (over 5%) with the exceptions of vending and CPO food were noted. The gross profit variation for vending showed a very marked improvement over prior periods. This was brought about by improved controls and record keeping instituted by the NAFA Officer. Transfer and issue documents from the warehouse to vending did not accurately reflect inventory received when compared to the vending machine operator's log of inventory issues. It is recommended that no inventory be issued to any activity from the warehouse without a transfer document properly signed by both parties to the transaction. This document should be posted to the warehouse inventory cards as soon as possible and forwarded to the bookkeeper for posting within 24 hours after the transaction occurred. The beginning inventory for the Vending Activity was determined NOT to be correct. (It is highly unlikely, when sodas are issued in case lots, that a beginning and ending inventory can be exactly the same to the penny, as shown on the report for the period ending 17 October 1977.) Unofficial records of the vending machine operator indicate that the beginning inventory for this report period should have been $222.83. Had it been possible to use this figure in the report a gross profit of 39.35% would have been shown for the period ending 31 January 1978.

5. CPO Food gross profit is down to 36.4% from 44.2%. This appears to have been caused by increased food costs not reflected in the selling prices and errors in taking inventory.

6. Pricing was tested to costs and it was determined that the pricing policies are for the most part being adhered to.

Subj: Independent Audit of Non-Appropriated Fund Activities; submission of

Merchandise is individually marked but not clearly. It is recommended that the price labeling machine be used to clearly indicate the price of each item in the package store and exchange and further that the machine also be used to date and cost code all items. When this task is accomplished for these activities no items should be drawn from the warehouse that are not properly labeled.

7. Cash is collected daily as required.

8. Sales receipts were compared with cash register readings and differences are noted and recorded.

9. Net profit of the exchange sales do not exceed 15% of total sales.

10. Authorized patrons are identified.

I. Purchases and Expenses

1. Written serially numbered purchase orders are used and properly approved. Verbal orders are confirmed by written confirmation purchase orders.

2. Invoices and supporting documents were tested for approval, receipt, and acceptance and were found to be in good order. Computations on invoices were tested and found to be accurate.

3. There were minor discrepancies noted in the Purchases Journal entries. Expense transactions had been posted as purchase transactions. It is recommended that the NAFA Officer advise the bookkeeper regarding this type of transaction and periodically check entries to prevent this in the future.

4. At present NAFA does not have or use a general ledger in its accounting system. It is recommended that a general ledger be set up immediately and used as this would not only provide a check on subsidiary ledger and journal entries and totals but would also make the compiling of NAFA Reports more facile. Purchase Journal and check register totals were tested and determined to be accurately entered.

5. Deliveries are properly inspected as to quantity and quality of merchandise and this is periodically spot checked by the NAFA Officer.

6. For the period under review it was determined that items purchased for resale were properly authorized and were acquired in reasonable quantities. However, upon review of the current exchange inventory it was noted that though previous period items purchased for resale may have been properly authorized they were not purchased in quantities based on actual needs. This problem will be addressed further in the conclusion of this report.

J. Taxes

1. Time constraints did not allow the audit board time to investigate the matter of taxes as outlined in Section 4m, Appendix F of Reference (a).

K. Other Audit Areas

1. Insurance and bonding is now covered by NAVRESO which has been determined to be adequate by Coast Guard Headquarters.

2. Coast Guard Trust Fund and District Morale Fund contributions were determined to be accurate, based on previous reports, and made in a timely manner.

3. The required letters of designation were on file.

4. Security for cash and inventory will be addressed in the conclusion of this report.

3. Summary and Recommendations

A. Cash management, control, and security was found to be lacking. On two occasions the audit board entered the NAFA Office to find the cashier absent and cash laying on the desk. All personnel responsible for cash must keep it under positive control at all times. Therefore, when the cashier must leave the office all cash should be removed to the safe provided for that purpose.

B. The vending machine operator does not count the cash removed from the machines. He collects the cash and leaves it with the cashier to count and make out the daily activity report. The operator apparently has a problem counting the cash. Coin counters were found during the audit which should be delivered to the operator to assist him in counting coins. He should do so and fill out his own daily activity report and receive an acknowledgement from the cashier for all funds turned in and account for any difference.

Subj: Independent Audit of Non-Appropriated Fund Activities; submission of

C. Some employees for each club have the combination to both the day shift and the night shift safe. This presents a control and accountability problem. A night depository drop has been requested and approval has been granted to acquire and install same with NAFA funds. NAFA's Financial condition at this time does not warrant paying the cost of this item from this source. It is recommended that the request be resubmitted for acquisition with appropriated funds. This would reduce the number of safes required in each activity to one. The number of change funds required for each of these activities would also be reduced to one.

D. On a number of occasions, unauthorized personnel were found behind the bar in the CPO Mess. This is due primarily to the present arrangement of the bar, food service, and office facilities. It is suggested that the bar be relocated on the south wall at the east end of the room. The depth of the bar area should be decreased when this is done which would increase bar security and efficiency. A pass-through window can be installed for food service from the bar.

E. The back door to the exchange store should be locked at all times and not used as an access by patrons. This would be an additional safeguard against shoplifting and provide better patronage control.

F. The NAFA Officer currently holds keys to all controlled areas. This presents a responsibility and accountability problem. Possession and control of keys to all NAFA spaces should be in accordance with reference (a).

G. Inventory Control

1. All personnel involved with taking inventory should be thoroughly briefed as to proper procedures. In addition, the proposed Inventory Verification Team should also be briefed on proper inventory procedures and how to control same. The exchange should be closed for two full days in order to ensure that a proper inventory is obtained and to reduce errors caused by teams trying to "rush the job". Weekends should be the preferred time to take inventory in order to keep business interruptions to a minimum. The bar and food inventories in the CPO Mess should be segregated.

2. Warehouse inventory problems and suggestions were addressed in Section D.2.b above. In addition, a better control system needs to be set up for the cigarette inventory. All issues from the warehouse should be in standard lots only and receipted for on delivery. Posting to warehouse records as soon as possible is necessary in order that transfer documents be posted to NAFA Records in a timely manner. Transfer documents should be serially numbered to ensure that none are missing during the accounting period.

3. An analysis of exchange sales and inventory needs to be made. It is believed that this will show that there is too much money invested in the clothing inventory. It was the observation of the audit board that too much exchange space was devoted to clothing and that an inordinate amount of employee time was taken up with assisting customers in clothing selection and maintaining the clothing displays. NAFA personnel should look into the best way to reduce the clothing inventory to a few selected items and sizes of casual wear that are more in demand by area personnel. The space gained by this process could be better utilized to displaying present merchandise more effectively and to add merchandise that has a higher turnover rate. The NAFA Officer should study and make this determination.

4. The audit board has determined by observation that the present exchange facility should not try to compete with the larger exchanges in the area and should confine its mode of operation to a "convenience store" style until such time as the financial condition of NAFA and the authorized patron population justify an expanded facility.

H. In general the NAFA Officer, CWO W. E. BARNES inherited a bad situation and has done much to improve overall control and operations of the activities. Had he not instituted some of the controls that he did, the audit board would not have had proper audit trails to follow in order to make some of the determinations that were made. More needs to be done as outlined earlier in this report. It is highly recommended that CPO Club Special Events and functions be dispensed with for a period of at least six months in order to allow the NAFA Officer time to implement the additional controls and accounting records recommended and to spend more time on much needed guidance to the bookkeeper in her posting and accounting procedures. The present accounting system is a McBee "one write" system. No instructions or general ledger could be found with the system. The NAFA Officer should contact the accountant that instituted the system and develop with him ways to obtain a general ledger from the system and how to use the system more effectively, to the end that development of the exchange report is made more facile.

(fbr)
7500
10 February 1978

Subj: Independent Audit of Non-Appropriated Fund Activities; submission of

I. For the first time since its inception, all major categories have had a positive total revenue for the period. Accounts Payable has been reduced by approximately 50%. Net Worth increased approximately $19,000 for the period which reflects a 21% increase over that of the prior period.

J. In view of the findings of this audit board, it is recommended that a thoroughly briefed audit team conduct another audit for the period ending 30 April 1978. The team should be headed by an officer, not attached to this command, who has an extensive accounting background. The members of the team should be provided with a copy of this report and any subsequent correspondence relative thereto in order to properly prepare for their duties. By doing so, it is felt that a fair and accurate financial condition can be determined for the Support Center Non-Appropriated Funds Activities for the first time since their establishment and subsequent reports will reflect more accurately the performance for the periods under review.

K. The audit board greatly appreciated the assistance of CWO W. E. BARNES and his staff for their cooperation and assistance with this audit.

APPENDIX C

DEPARTMENT OF TRANSPORTATION
UNITED STATES COAST GUARD

MAILING ADDRESS

7500
12 April 1978

From: Elizabeth City Coast Guard NAFA Audit Board
To: Commanding Officer, U. S. Coast Guard Support Center, Elizabeth City, North Carolina

Subj: Report of Semiannual Audit

Ref: (a) Commander, USCG Air Base, Elizabeth City ltr dtd 19 Dec 1977
(b) Coast Guard NAFA Manual (CG-146)
(c) Coast Guard Special Services Manual (CG-207-4)

1. An audit of all Support Center NAFA activities covering the six month period of August 1977 thru January 1978 has been conducted in response to Reference (a). Observations and associated comments are submitted herewith.

2. In conducting this audit we complied with the requirements of Reference (b), utilizing check lists and procedures therein as well as additional standard check lists and review procedures. Again this year, we reviewed all facets of the NAFA organization but concentrated our attention on operational practices. This seemed particularly appropriate this year in view of the DOT audit having been conducted during the Summer and Fall of 1977, and the annual independent audit being conducted during part of that same period.

3. The NAFA Manual (CG-146) is becoming a less satisfactory operating guide with each passing year, both for NAFA personnel and for audit purposes. The basic publication, inadequate when new, is now five years old, and the latest amendment was issued three years ago. The Coast Guard NAFA organization and the regulations effecting its operation are dynamic and thus require regularly updated guidance on which to base policy and operations. We noted several minor instances of the Elizabeth City NAFA organization straying from the provisions of CG-146. Except as noted herein, we find no fault with these changes. It has been our experience that deviation is common throughout the Coast Guard NAFA organization, precipitated largely by existing policy guidance which is outdated and inadequate. We hope that the forthcoming revision of CG-146 will adequately address the requirements and problems of a modern and efficient standardized Coast Guard NAFA system.

4. We reviewed the DOT audit dated 1-6-78; however, due to its recency, we did not check for implementation of the recommendations contained therein. We noted that some of the topics addressed had been mentioned by this board in one or more previous reports but had not been commented on at the District level.

7500
12 April 1978

Subj: Report of Semiannual Audit

5. We reviewed the independent audit conducted by Brittingham & Thiem dated 1 August 1977. The auditors recommend the use of a year-end written, descriptive inventory in lieu of the commercial inventory team. We first observed the commercial inventory team in 1975. At that time, we noted some significant errors in their inventory and a lack of knowledge on the part of some NAFA employees regarding how best to prepare for, utilize and double check the team. It was our opinion at the time that this was a worthwhile service and that satisfactory results could be attained with increased NAFA employee familiarity and preparation. Since then, NAFA has used the team regularly. We have observed them annually. NAFA employees have become highly competent in working with the inventory team members. Preparation is adequate, and a dual system of double checks is used. Some zones are precounted by NAFA employees, others are recounted by an inventory team member other than the person taking the initial count. The results are very accurate, exceeding that which can reasonably be expected from a written inventory. As a result of our observation of both the inventory taking process and the results thereof, it is our opinion that there is nothing to be gained by utilizing a year-end written descriptive inventory.

6. Observations and comments; financial, administrative, and general operations:

a. Cash Management

(1) Change, check cashing and petty cash funds were checked and found in good order with the minor exception of a fifteen-cent shortage in the COMD Bar change fund.

(2) Letters of authorization were reviewed and found in good order.

(3) Cash books, sales journal and cash receipts were reviewed. We note that the club managers are not given a receipt for the funds they turn in to the cashier.

b. Accounting Records and Financial Operations

(1) All accounting records were reviewed and found in good order.

c. Administration

(1) We note that CG-4533 (Exchange Statement of Financial Condition) is being used in lieu of CG-4533A (Exchange Statement of Financial Condition - Large Exchange) and an outdated edition of CG-4534A (Analysis of Net Worth) is being used. This is a minor point; however, the correct forms are somewhat different from the ones in use so we recommend that they be ordered and

utilized. We note also that a locally-revised edition of CG-4531 (Exchange Activity Statement) is being used. This local edition provides a breakdown of "operating expenses" (lines 13 thru 19) into "direct operating expenses" and "administrative expenses". This breakdown is informative for all administrative levels. While we certainly agree with the concept, we wonder if the goal might be more effectively accomplished by revising the detailed "Individual Activities Expense Reports" rather than CG-4531. This document provides a more spacious format in which to develop the different expense categories.

(2) Again this year, we note that examined copies of reports are not being returned from District (fbr). This, and the absence of comment on some previous audits potentially weakens the working relationship between District and Unit levels.

(3) We asked for, and received, a patron count for the last two years operation of the barber shop. For both years the annual patron count was approximately 8500. The fee for a standard hair cut during the period was $1.75. Effective January 1978, the fee for a standard haircut was increased to $2.00. This is still well below the average price for this area, thus the barber shop is providing a worthwhile service. As we noted last year, the monthly rent of $20.00 appears to constitute a significant subsidy. Considering the return from barber shop operations, we feel that a subsidy is not necessary and recommend that a break-even cost for this facility be established and the rent increased to at least that amount.

(4) Two topics came to our attention which suggest a possible need for better communication between management and employees. The first and perhaps most significant was a question concerning recent pay raises that did not include AS grades 4 thru 7. The second question concerned the apparent disregard for in-house promotion policy in the recent filling of a bookkeeper position. We did not attempt to answer these questions but make mention of them here for management's consideration.

(5) (a) The last two years we addressed the topic of Morale and NAFA funds being mixed in the operation of the Morale (recreation) Locker. The facility is basically funded by the Morale Fund, but it is administered by, and profits (albeit small) from its operation are returned to, NAFA as other income (line 6, CG4534A).

(b) Recently, a Recreation Assistant has been added to the staff. It is our understanding that he is a Special Services employee; however, his salary is paid directly by NAFA and accounted for as an activity on CG-4531.

(c) Reference (c) states that the Commanding Officer may designate the NAFA Officer as administrator of Special Services and the Morale Fund.

It does not, however, provide for mixing the two funds. It is this aspect of the operation that concerns us. We recommend that one of the following alternatives to the present operation be considered: 1) Seperate all accounting and financial activity of the Morale Fund and NAFA and account for Morale Locker and the Recreation Assistant under the Morale Fund. 2) Seperate the funds and bring the Morale Locker and the Recreation Assistant fully under NAFA as NAFA activities. Inasmuch as such activities are not authorized under A04001 of Reference (b), this move would require a waiver. In reviewing NAFA responses to our previous comments on this topic, it appears that the latter approach would be preferred by NAFA management. We agree with this view and recommend that a waiver be requested.

7. Observations and comments; activities

a. Exchange Store

(1) Crowded facilities and remote storage continue to be the Exchange's greatest problems. Remote storage facilities are particularly costly in manhours and efficiency. Typically, a large shipment of health and beauty aid products will be received into the main storeroom. The smallest subdivision of that shipment will be moved half a city block to a small storeroom in the Exchange. Then the shelf will be filled from that stock. Thus, the item has been handled five or six times from receipt to customer. The same item also has to be inventoried in three separate locations. New, more efficient display shelves have been obtained and are scheduled to be installed in the near future. This should alleviate crowding within the store. Considering the conditions under which they operate, the Exchange employees do a commendable job.

(2) The Small Stores operation has been expanded somewhat since last year; however, display areas for these articles are still inadequate and popular sizes and items are often out of stock. Items may be special ordered but lead time is highly variable. At least one of the tenant commands makes special trips to Yorktown to obtain Small Stores articles for their personnel. Small Stores operations are not profitable but they are a significant factor in personnel morale and well being which is the bottom line of all NAFA operations. We recommend consideration of either additional area in the Exchange dedicated to Small Stores items, or the development of a separate Small Stores facility. Such a facility could be operated by military personnel on reduced scheduled hours.

(3) We noted a small number of men's suits in the Exchange. Men's suits are not an authorized article for sale in CONUS exchanges. We were advised that the Exchange has not and will not carry men's suits and that these articles were inadvertently ordered as the result of some

confusion about their description. Apparently the NAFA buyer did not realize that they would come as a complete suit assembly. Returning the articles was deemed too costly, thus a decision was made to sell them on a one-time basis; a decision with which we concur.

(4) (a) Inventory control continues to be an item of concern to the Board. We note that as of 1-31-78 the Exchange inventory value was in excess of 2½ months sales. The Exchange entered the Christmas period with an inventory value on 1 November 1977 in excess of 3½ months sales. Inflated inventories at that time of year are normal and the 17% decrease during the period indicates that pre-season buying was well planned. The simple fact of an inventory level being in excess of 2½ months sales is not a cause for concern but it does require that management be fully aware of what the inventory dollars are invested in, and why the level is as high as it is. On the desirable side, high inventory levels can insure against stock out of popular items, can result in savings due to quantity buying, and can provide an attractive variety of merchandise for customers to choose from. On the undesirable side, high inventory levels can harbor poor selling merchandise and/or unnecessarily high levels of steady demand items. The existence of either one of these conditions tends to reduce the potential benefits of high inventory levels.

(b) The basic tools for preventing overstock of good sellers and dusty stocks of poor sellers are inventory control records and dated price tags. Both of these tools are now employed by the Exchange, but our observation is that neither is utilized to its optimum potential. A brief review of the inventory cards revealed several erroneous stock levels (corrected by a physical inventory) stock outs, and potential overstocks. We encourage continued and expanded use of available inventory controls.

(5) The Exchange inventory is in four segments. The main storeroom, storage trailer, and Exchange building storeroom were inventoried by NAFA personnel and spot checked by an auditor. The Exchange store itself was inventoried by the commercial team. The NAFA pre-count figure was within .16% (.0016) of the final figure on $12,294.40. The re-count and final figures were within .14% (.0014) of first count figure on $35,884.60. One zone contained a gross error which was detected by NAFA personnel and corrected with two subsequent counts.

b. Grocery Store and Warehouse

(1) The Grocery Store has been rearranged since our last audit and additional cold storage space has been provided. We found the facility clean and orderly with well-stocked shelves and expanded/improved merchandise selection.

Subj: Report of Semiannual Audit

(2) The warehouse was clean and well organized. This was the first time in four years that we found no evidence of smoking in the stock area.

(3) The Grocery Store was inventoried by the commercial team. A series of pre-counts and recounts was used by NAFA personnel to establish the accuracy level of inventory figures. The recount figures were within .03% (.0003) of inventory figures on $11,624.95; the NAFA pre-count within 07% (.0007) on $6,171.06.

(4) The Grocery warehouse was inventoried by a team of three NAFA personnel; counter, checker, and recorder. A statistical degree of accuracy was not determined for this inventory; however, several sections of the inventory were monitored by an auditor and observed to be satisfactory.

(5) We noted last year that sales for this facility were down. However, we expressed optimism that sales would increase with recently improved management and stocking policies. Unfortunately, sales are down still further this year while expenses (primarily salaries) are up. In a continuing effort to bring this facility up to a sound financial level, management has initiated variable pricing with the associated ability to run weekly specials. Although firm data are not yet available, indications are that this new policy has resulted in a significant increase in sales. We applaud all sound efforts to generate the patronage this facility is well capable of serving. We again express optimism that sales will increase. The current construction of 50 plus additional units of Coast Guard housing in close geographic proximity to the Base should have a positive effect on sales. We encourage increased use of command bulletin boards as a means of informing personnel about the advantages this facility has to offer.

c. Country Store

(1) The Country Store continues to impress us as a well managed operation. We note though that the inventory has grown disproportionately to sales. Although still under 2½ months sales the inventory values include approximately 10% beverages which are subject to a much lower stocking guide (1 month or less). Thus, the remainder of the merchandise has reached a stock level that may require slightly closer monitoring.

(2) The Country Store was inventoried by the commercial team and checked by NAFA pre-counts and inventory team recounts. Check figures were within .05% (.0005) of inventory figures on $14,013.27.

Subj: Report of Semiannual Audit

d. CPO Club

(1) Overall material condition of the Club was very satisfactory except for the back bar area which was in need of a field day. The dishwasher is inoperative so dishes are being hand washed, apparently satisfactorily at least from a sanitation viewpoint. We recommend early replacement of the dishwasher with a commercial model.

(2) A dual inventory was taken with no discrepancies noted.

e. COMD

(1) The COMD has greatly improved its food operation, more than doubling sales since last year. The facility was in good material condition. Our compliments to those responsible for such a significant change.

(2) Although the inventory was not excessive, we feel this is an area that will require close attention to keep dead stock from accumulating. Physical inventory was taken by two NAFA personnel and verified by an auditor.

f. Enlisted Club

(1) This facility was clean and apparently well organized. We note that food sales have increased well since last year.

(2) Microwave oven warning signs should be posted in conspicuous areas.

(3) The inventory was taken by two NAFA personnel and verified by an auditor.

g. Package Store

(1) The Package Store was clean and well arranged. The rate of stock turnover indicates good management. Stock and shelves were dual inventoried with no discrepancies noted.

h. Thrun Hall Snack Bar

(1) Overall material/sanitary condition was satisfactory. An old Hamilton mixer which is no longer used should be surveyed and disposed of. Empty chest-type freezer should be defrosted and disposed of if no longer required. Popcorn popper is in need of a good cleaning.

(2) No discrepancies were noted during the physical inventory.

i. Guest Housing

(1) All the guest housing units were occupied so we did not inspect them this year. The grounds and support facilities were clean and orderly.

j. Morale Locker

(1) The Morale Locker appearance and organization have improved dramatically since last year. The equipment is being maintained in a good state of repair, records are current and accurate and the facility was clean and orderly.

8. The rate of change in the NAFA organization has slowed. Many of the objectives of the last few years have been realized. Organization, administration and the material condition of the facilities have improved in great measure since our first audit four years ago. We compliment the entire NAFA staff on their continuing dedication to the organization and its purposes.

9. We wish to express our appreciation to Mr. Grant and the many NAFA staff members who assisted us with this audit.

P. K. BOTHMANN, LT, USCG
Senior Board Member

Audit Board Members:
CWO W. A. GREGORY
CWO E. M. HARBESON
CWO R. C. HARRELL
SKC W. C. AYDLETT

Form DOT F 1320.1 (1-67)

UNITED STATES GOVERNMENT

Memorandum

DEPARTMENT OF TRANSPORTATION
OFFICE OF THE SECRETARY
Office of Audits

DATE: January 6, 1978

SUBJECT: Report on Audit of Non-Appropriated Fund Activities, Air Base Elizabeth City
Report Number AT-CG-78-4.5

In reply refer to: TAD-75.4
Suite 114-B
1568 Willingham Drive
Atlanta, Ga. 30337

FROM : Regional Audit Manager, Atlanta Region

TO : Commander, Fifth Coast Guard District

We have completed our audit of Non-Appropriated Fund Activities at USCG Air Base Elizabeth City. Two copies of the final report are attached.

The objectives of the audit were to evaluate: (1) policies and procedures for use of non-appropriated funds, (2) accounting procedures and internal controls, (3) management of exchange and club activities, and (4) management of loan operations. Our audit observations and recommendations are summarized in section II and discussed in detail in section III of the report. The observations are concerned with needed improvements related to: (1) utilities, (2) personal property, (3) administrative practices, (4) cash collections, and (5) morale funds.

Your comments are summarized following our recommendations in section III and are included as Exhibit A to the report. We would appreciate receiving your comments within 90 days on the status of actions taken or planned on all open matters discussed in the report and periodically thereafter in accordance with section 8.g., DOT Order 2920.1A.

We appreciate the cooperation and courtesies extended to our staff during the audit.

REPORT ON AUDIT OF NON-APPROPRIATED FUND ACTIVITIES

I. INTRODUCTION

We have completed our audit of the Non-Appropriated Fund Activities at the United States Coast Guard (USCG) Air Base Elizabeth City. The objectives of the audit were to evaluate: (a) the policies and procedures for use of non-appropriated funds, (b) the adequacy of accounting procedures and controls, (c) the management of exchange and club operations, and (d) the management of loan operations. The audit was performed at the USCG Air Base Elizabeth City, North Carolina.

II. SUMMARY OF RESULTS OF AUDIT

We found that the Non-Appropriated Fund Activities (NAFA) at Air Base Elizabeth City were generally being administered and operated in accordance with prescribed policies and procedures and in the best interest of the Coast Guard. We also found that accounting procedures and controls for the resale activities and the morale and welfare funds were adequate in most respects.

We noted, however, five areas in which improvements were needed to ensure compliance with regulations and to improve cash flow. These areas relate to (a) utilities, (b) personal property, (c) administrative practices, (d) cash collections, and (e) morale funds. Our observations and recommendations are summarized below and discussed in detail in section III of the report.

A. NAFA had not fully reimbursed the Coast Guard for the cost of electricity and water consumed by NAFA facilities. A written utility agreement specifying services, rates to be charged, and basis for computation of charges had not been executed as required. As a result appropriated funds had been used to subsidize NAFA utility usage. We recommend the Air Base and NAFA enter into a written utility agreement and that the Air Base identify utility consumption by NAFA facility. (Para. III.A.)

B. A complete listing of accountable NAFA property needs to be prepared. We found that some NAFA property was not included on the NAFA property records, some property listed could not be located, and information concerning many items was incomplete. As a result NAFA property was not being controlled and accounted for. Without a complete property listing NAFA did not have a basis for the amount of insurance coverage and may not have information necessary to file a claim for loss or damage. We recommend NAFA develop a complete listing of all accountable property and develop a systematic method to record all changes in property. (Para. III.B.)

C. Several NAFA administrative practices need to be improved to comply with the NAFA Manual and other regulations. We found instances in which NAFA had either not complied or had not documented compliance with requirements pertaining to authorizations, restrictive notices, sales slips, price lists, and personnel files. As a result some aspects of NAFA may not be providing optimum benefits to authorized patrons. We recommend NAFA improve its administrative practices to be in compliance with the NAFA Manual and other regulations. (Para. III.C.)

D. Local regulations pertaining to employee shopping, lay-a-ways, and vending machines need to be enforced. We found that some customers and employees were not complying with regulations and some vendors were not paying commissions in accordance with their contracts. As a result NAFA had not received all cash on time. We recommend that NAFA: (1) require customers and employees to comply with regulations pertaining to employee shopping, lay-a-way payment terms, and collection of coins from amusement machines and (2) establish procedures to identify late and incorrect payments of vending machine commissions and cigarette display allowances. (Para. III.D.)

E. Morale fund allotments made to tenant commands should be adjusted by the Air Base. Spending levels of the tenant commands did not correspond with the size of their quarterly allotments. As a result two of the three tenant commands maintained substantial checking account balances which could be used for other morale activities or which could be earning interest in a savings account. We recommend the Air Base: (1) require the tenant commands to reduce the size of their checking accounts and (2) recompute the quarterly allotments to the tenant commands. (Para. III.E.)

The District concurred with our observations and recommendations and advised that action necessary to implement the recommendations will be completed by March 31, 1978. The District's specific comments are included as Exhibit A of the report.

III. DISCUSSION OF RESULTS OF AUDIT

A. Utilities

1. Observation

Non-Appropriated Fund Activities (NAFA) had not fully reimbursed the Coast Guard for the cost of electricity and water consumed by NAFA facilities. A written utility agreement specifying services, rates to be charged, and basis for computation of charges had not been executed as required. As a result appropriated funds had been used to subsidize NAFA utility usage.

The NAFA and Comptroller Manuals require NAFA and the Air Base to execute a written utility agreement describing services, rates to be charged, and basis for computation of charges. NAFA is required to reimburse the Government for the cost of water and electricity consumed by all NAFA facilities except Enlisted Men's and Officers' Clubs. However, NAFA is to pay for utilities at Officers' Clubs when the facilities are being used for other than essential feeding. Meters are to be installed to measure consumption where practical. When meters are not feasible, an estimate based on an engineering analysis is to be used.

NAFA had been paying a flat rate based on an engineering analysis for water and electricity since 1971. The Coast Guard Audit Board reported that the utility charges appeared to be low and recommended the charges be reviewed. Subsequently, three electricity meters were installed, and beginning January 1, 1977 NAFA was billed for consumption recorded on these meters.

While installation of meters improved the reasonableness of the utility charges, the bill did not include water and electricity used by unmetered NAFA facilities. These unmetered facilities included the package store, grocery warehouse, exchange warehouse, and Officers' Club. Air Base personnel indicated that engineering estimates would be developed to determine water and electricity charges for these unmetered areas. We also found that NAFA had not paid the utility charges on vending machines as required. The NAFA Manual suggests a flat rate of $1.75 per machine per month except for machines located on club or mess premises.

NAFA distributed utility costs to the various cost centers differently each time a bill was paid in FY 77. The distribution appeared to have little relationship to utility usage. For example, the exchange and grocery store were frequently charged with the same amount of utility costs, but the meters showed the grocery had a much higher consumption than the exchange. After meters were installed NAFA continued to distribute costs to unmeter-

ed facilities including the Enlisted Men's Clubs. Although the bills sent to NAFA provided only a total for the three meters, Air Base personnel stated that a breakdown of costs for each meter could be provided. Improvements in distributing utility expenses among NAFA cost centers will result in a more realistic statement of net profits or losses for each activity.

2. Recommendations

We recommend the District:

a. Require the Air Base and NAFA to enter into a written agreement covering electricity and water usage by vending machines and NAFA facilities except exempted clubs, and

b. Require the Air Base to provide electricity and water usage data in a format suitable for identifying costs to be distributed among the NAFA cost centers.

3. Official Comments

The District concurred with our observation and recommendations and advised that action necessary to implement the recommendations will be completed by March 31, 1978.

B. Personal Property

1. Observation

A complete listing of accountable Non-Appropriated Fund Activities (NAFA) property needs to be prepared. We found that some NAFA property was not included on the NAFA property records, some property listed could not be located, and information concerning many items was incomplete. As a result NAFA property was not being controlled and accounted for. Without a complete property listing NAFA did not have a basis for the amount of insurance coverage and may not have information necessary to file a claim for loss or damage.

The NAFA Manual states that the NAFA officer will maintain records and be accountable for property purchased by NAFA or transferred to NAFA from available Coast Guard equipment. Property records will be maintained for furniture and equipment with a unit cost of $200 or more and personally attractive items with a unit cost of less than $200 (e.g. adding machines, calculators, typewriters, and vending machines). The property records will show date of purchase or transfer, purchase order or transfer document number, unit value, description, location, and custodian. Inventories will be conducted annually.

NAFA did not establish a listing of its property until 1975. At that time NAFA personnel assumed all property located in NAFA facilities and not shown on the appropriated funds list of property belonged to NAFA. Because purchase dates and amounts were not known for many of the items, this information was estimated or omitted. We found many instances in which required information such as purchase dates and amounts were also not recorded for property acquired after 1975. The most notable examples were furniture and equipment purchased for the new Enlisted Men's Club.

NAFA personnel provided computer printouts dated December 30, 1976 listing NAFA property. These listings had been signed by the various custodians -- generally managers of each activity -- to indicate that the property had been inventoried. Penciled changes were made to the printouts to indicate corrections made at the time of inventory as well as additions and deletions made since the inventory. NAFA also provided records obtained from Air Base personnel listing property purchased with appropriated funds that was being used by NAFA.

Using the appropriated and non-appropriated property lists, we randomly checked furniture and equipment at several NAFA facilities. We found that some accountable items were not on either property list, others were on both lists, and some property listed could not be located.

We noted several instances where pencil changes made to the computer listing were incorrect. For example, when one of the cash registers at the Chief Petty Officers' Club was replaced, the wrong cash register was deleted from the list.

The problems noted with the property records appeared to result from three primary factors. First, a complete listing had never been prepared. Second, NAFA management personnel primarily relied on each custodian to make additions and deletions to his property list and to request decals for new furniture and equipment. However, the custodians were relying on management to make the changes and to provide decals when appropriate. Third, the custodians did not take thorough physical inventories. In many instances they counted the units fitting the description rather than matching serial/decal numbers to the inventory list. Also the custodians inventoried to determine that all items on the property lists were on hand. They did not inventory to determine that all accountable furniture and equipment in their facilities was recorded on the inventory list.

NAFA needs to prepare a complete listing of all accountable property. In addition NAFA needs to establish practices whereby one person is assigned responsibility for receiving and recording information on all property acquired and for issuing property accountability decals to the custodians.

2. Recommendations

We recommend the District require NAFA to:

a. Develop a complete listing of all accountable NAFA property, and

b. Develop a systematic method to record all changes in accountable property.

3. Official Comments

The District concurred with our observation and recommendations and advised that action necessary to implement the recommendations will be completed by March 31, 1978.

C. Administrative Practices

1. Observation

Several administrative practices need to be improved to comply with the Non-Appropriated Fund Activities (NAFA) Manual and other regulations. We found instances in which NAFA had either not complied or had not documented compliance with requirements pertaining to: (a) authorizations, (b) restrictive notices, (c) sales slips, (d) price lists, and (e) personnel files. As a result some aspects of NAFA may not be providing optimum benefits to authorized patrons.

The specific practices which were not in compliance with the regulations were:

a. The District Commander had not given his written authorization for the car wash operated by NAFA. According to the NAFA Manual any additions to the exchange activities must be authorized in writing by the cognizant district commander. The Manual states "Letters of Authorization shall list specifically each exchange activity authorized thereby, and such authorizations shall be retained by the exchange in permanent files readily available for inspection."

b. The Air Base Commander had not documented his specific approval of items of merchandise stocked by the exchange. The NAFA Manual states "Exchanges are authorized to stock and sell only those items of merchandise listed herein. They may be stocked by the exchange officer, however, only after specific approval of the commanding officer has been received."

c. The Air Base Commander had not given written approval for the sale of ammunition. The NAFA Manual states that ammunition will be sold only with the written approval of the commanding officer.

d. The exchange did not have a sign posted stating the locally imposed cigarette limitation or a sign stating that goods could not be resold. The package store did not have a sign posted stating the quantity of liquor which could be legally transported under North Carolina law. These signs are required by the NAFA Manual.

e. Sales clerks had not properly filled out 22 percent of the sales slips reviewed. Omissions included reasons for purchases, customers' signatures, dates, clerks' initials, and prices. The NAFA Manual requires sales slips be prepared for the sale of single items of merchandise priced at $25 or more except articles of military uniforms.

f. The exchange and grocery store had not posted price lists for candy bars, paperback books, greeting cards, cigarettes, service medals, and bread. The NAFA Manual requires price lists to be conspicuously displayed and/or all items to be clearly marked.

g. NAFA had not required employees to sign refusal cards when electing not to participate in the group insurance and retirement plans. The cards are to indicate that the employees have been interviewed and understand the advantages and benefits of the plans. Although some employees were participating in one or both plans and other employees were not eligible to participate, we identified a number of employees who should have signed retirement and/or group insurance refusal cards. These refusal cards are required by the NAFA Manual and by the Administrative Manuals for the Group Insurance Plan and the Retirement Plan of the USCG Resale Programs.

h. We reviewed official personnel files for 10 of the 54 employees and found that 6 of the 10 did not contain properly executed employment agreements. Three of the six files did not have any agreements; the remaining three files had unsigned agreements. A signed employment agreement is required by the NAFA Manual and NAFA Directive #3.

i. NAFA maintained separate files for several types of information required to be in official personnel files. These records pertained to insurance, retirement, pay rates, and Federal and State tax withholdings. The NAFA Manual requires these records to be maintained in the personnel file of each employee.

2. Recommendation

We recommend the District require NAFA to improve the administrative practices discussed above to be in compliance with the NAFA Manual and other regulations.

3. Official Comments

The District concurred with our observation and recommendation and advised that action necessary to implement the recommendation will be completed by March 31, 1978.

D. Cash Collections

1. Observation

Local regulations pertaining to employee shopping, lay-a-ways, and vending machines need to be enforced. We found that some customers and employees were not complying with regulations and some vendors were not paying commissions in accordance with their contracts. As a result the Non-Appropriated Fund Activities (NAFA) had not received all cash on time.

a. Employee Shopping - NAFA Directive #09 requires all items sold to employees be wrapped and securely stapled with the cash register tape visible. The wrapped package is to be held in a storage area rather than the employees' work area. Items of merchandise are not to be removed from the sales floor and held behind counters for later purchase.

During our audit we observed several employees removing items from stock and returning to their work areas with the merchandise without having it wrapped or having a sales slip attached in an obvious place. In some instances the merchandise remained in the work area for several days or even several weeks.

To ensure that all merchandise is properly controlled and to eliminate opportunities for pilferage, NAFA should enforce its procedures pertaining to employee shopping.

b. Lay-a-Way - Air Base Instruction 7010.1B states that customers using the lay-a-way plan will pay 10 percent of the sales price at the time of lay-a-way and will pay one-third of the balance at 30, 60, and 90 days.

We reviewed the 20 lay-a-ways which were at least 30 days old on the day of our review and found that all 20 had payments overdue. One-half of the lay-a-ways reviewed were more than 90 days old and should have been paid-in-full. Eleven of the 20 lay-a-ways belonged to NAFA employees. The 20 lay-a-ways represented $1,077.83 in sales, and of that amount $414.27 (41 percent) were past due payments. We also noted that customers were asked to sign a copy of the lay-a-way terms but were not given a copy to take with them.

To improve the cash flow and to avoid the possibility of old or out-of-season merchandise being returned to stock, NAFA should enforce its lay-a-way terms.

c. Vendor Operations - NAFA Directive #08 requires the club manager or NAFA representative to participate with the concessionaire in counting revenue from each concessionaire-operated amusement machine. We reviewed 21 receipts from Elizabeth City Music Company and found 13 had not been signed or initialed by NAFA employees to indicate participation in counting the coins. This involved all clubs operated by NAFA.

While reviewing the commissions paid to NAFA, we found two vendors had not paid commissions and one cigarette company had not paid a display allowance in accordance with their contracts. One vendor whose contract specified four cents had paid a commission of three cents a pack for cigarettes during the 16-month period reviewed. This penny per pack amounted to about $370 for the 16 months. The second vendor had not sent NAFA a $163.75 check for commission earned in May 1977 although commission checks for June and July had been sent. The cigarette company had not paid $84 due to NAFA as a display allowance for two quarters. After we advised NAFA officials of these observations, NAFA notified the three companies. Two had paid the amounts due by the time our field work was completed.

To ensure that each payment is received and computed in accordance with the terms of the contracts, NAFA needs to initiate a procedure to review vending machine commissions and cigarette display allowances.

2. Recommendations

We recommend the District require NAFA to:

a. Enforce the NAFA directive pertaining to employee shopping,

b. Enforce the lay-a-way payment terms and provide a copy of the terms to each lay-a-way customer,

c. Ensure that NAFA personnel sign each receipt for cash collected from amusement machines at the three clubs, and

d. Establish practices to identify late and incorrect payments of vending machine commissions and cigarette display allowances.

3. Official Comments

The District concurred with our observation and recommendations and advised that action necessary to implement the recommendations will be completed by March 31, 1978.

E. Morale Fund

1. Observation

Morale fund allotments made to tenant commands should be adjusted by the Air Base. Spending levels of the tenant commands did not correspond with the size of their quarterly allotments. As a result two of the three tenant commands maintained substantial checking account balances which could be used for other morale activities or which could be earning interest in a savings account.

The Air Base Commanding Officer is the administrator of a unit morale fund which serves personnel assigned to the Air Base (the host command) as well as personnel assigned to the three tenant commands: Elizabeth City Air Station, Atlantic Strike Team, and Aircraft Repair and Supply Center (ARSC). The Air Base Commanding Officer allotted funds quarterly to the three tenant commands for their own morale use. These funds were still considered as part of the assets of the Air Base morale fund and were reported to the District on a consolidated financial report.

We found the quarterly allotments were not in line with the spending habits of the tenant commands. The Air Station and ARSC, which each received $175 quarterly, spent an average of only $86 per quarter. The Strike Team received $50 per quarter, but spent an average of $63.

Although the Air Station and ARSC each requested only four allotments in the seven quarters reviewed, by April 30, 1977 the Air Station had accumulated $608.57 in its checking account and the ARSC had accumulated $312.62. At their average spending levels of $86 per quarter, the Air Station and ARSC will not spend the money in their checking accounts for 21 and 11 months respectively. The funds in excess of current needs could be made available for complex-wide morale activities or could be earning interest in a savings account.

The size of the checking accounts should be reduced to meet only current needs, and the allotments should be recomputed to correspond with the quarterly needs of the tenant commands.

We found the Air Station was using part of its morale fund allotment to make loans. From May 1, 1976 through June 16, 1977 the Air Station made 20 loans, about the same number made by the Air Base Morale Officer. Because of the balancing nature of the consolidated quarterly financial report, the Air Station loans were not reported to the District.

We could not find documentation stating the Air Station Commanding Officer had authority to make loans from his allotment. All regulations state that the Air Base Commanding Officer, the administrator of the unit morale fund, must approve all morale loans. In discussing this matter with Air Base and Air Station personnel, they agreed that the Air Station had not been given authority to make loans and agreed to discontinue the practice.

2. Recommendations

We recommend the District require the Air Base to:

a. Direct the tenant commands to reduce the size of their checking accounts,

b. Recompute the quarterly allotments to the tenant commands to correspond with their spending levels, and

c. Ensure that the Air Station discontinues the practice of making loans from its morale fund allotment.

3. Official Comments

The District concurred with our observation and recommendations and advised that action necessary to implement the recommendations will be completed by March 31, 1978.

IV. BACKGROUND

The Coast Guard Non-Appropriated Fund Activities (NAFA) consist of two classifications: those which provide goods and services on a resale basis to authorized patrons and those which promote the morale, recreation, and welfare of the Coast Guard members. The NAFA Officer at the Air Base in Elizabeth City is responsible for the management and operation of all resale activities as well as the morale and recreation activities. The Air Base Commander administers the welfare fund and the extraordinary expense fund.

During FY 77 the resale activities were accounted for under 19 cost centers. Ten of these cost centers were for activities at the Officers', Chief Petty Officers', and Enlisted Men's Clubs. The gross sales in FY 77 were about $2.3 million; the net profit was about $76,500.

Profits earned by the Elizabeth City resale activities are used to pay all expenses of the local morale and recreation activities except for occasional large expenditures paid by Coast Guard Headquarters and certain types of expenses paid with appropriated funds. A portion of the resale revenue is also remitted to the Headquarters trust fund and to the District morale fund. The welfare and extraordinary expense funds at Elizabeth City are funded by the District. The morale fund spent $8,852 in FY 76 and through three quarters of FY 77 spent $7,845. In addition $18,830 was sent to the Headquarters trust fund and District morale fund in FY 76 and $14,685 had been sent for the first three quarters of FY 77.

Policies and procedures for administering and operating the various types of NAFA activities are set forth in the Manual for Non-Appropriated Fund Activities (CG-146), the Special Services Manual (CG-207-4), the Manual for Administration of Coast Guard Welfare, and various other directives.

V. SCOPE

Our audit was performed in accordance with audit standards established by the Comptroller General. Our audit included: (a) an evaluation of compliance with applicable legislation and regulations and (b) an evaluation of the management and administration of the Non-Appropriated Fund Activities (NAFA) resale operations and the morale, welfare, and extraordinary expense funds. Our review was limited to the activities at the Air Base and did not include District office activities.

We reviewed applicable legislation, regulations, policies, procedures, and controls concerning the resale activities and the various funds. The audit generally covered program activities during NAFA's FY 76 and the first three quarters of FY 77. When possible the fourth quarter of FY 77 was also included. Selective testing techniques and other auditing procedures were used as considered necessary.

VI. PERSONNEL CONTACTED

Officials and/or staff members of the following organizations were contacted during our review:

Fifth District Headquarters, Portsmouth, Virginia
- Office of the District Commander
- Comptroller Division

Air Base Elizabeth City, North Carolina
- Office of the Air Base Commander
- Non-Appropriated Fund Activities Division
- Public Works Division

VII. AUDIT COUNSEL

We will provide whatever audit counsel you may desire on any matter discussed in this report.

EXHIBIT A

DEPARTMENT OF TRANSPORTATION
UNITED STATES COAST GUARD

MAILING ADDRESS:
COMMANDER (fbr)
FIFTH COAST GUARD DISTRICT
FEDERAL BUILDING
431 CRAWFORD STREET
PORTSMOUTH, VIRGINIA 23705

7500

15 DEC 1977

From: Commander, Fifth Coast Guard District
To: Regional Audit Manager, Department of Transportation, Office of the Secretary, Atlantic Region

Subj: Draft Report on Audit of Non Appropriated Fund Activities, USCG Air Base, Elizabeth City, NC

Ref: (a) DOT OST Office of Auditor memo dtd 18 Oct 1977
(b) DOT OST Office of Auditor memo dtd 4 Nov 1977

1. The recommendations contained in reference (a) are concurred with. Elizabeth City Air Base will be directed to implement your recommendations.

(See Auditor's Note)

3. All action necessary to implement the recommendations contained in reference (a) shall be completed by 31 March 1978.

LIST OF REFERENCES

1. Guidelines for Economy and Efficiency Audits of Federally Assisted Programs, U.S. General Accounting Office, 1978.

2. GAO Manual for Guidance of Federal Agencies, U.S. General Accounting Office, 1979.

3. Pomeranz, F., Cancellieri, A. J., Stevens, J. B., and Savage, J. L., Auditing in the Public Sector, Coopers & Lybrand, 1976.

4. McBride, T. F., "The Role of Audit Under the Inspector General Concept", The Government Accountants Journal, Vol. XXVIII, Number 1, Spring 1979.

5. Brink, V. Z., Cashin, J. A., Witt, H., Modern Internal Auditing, 3rd ed., John Wiley & Sons, Inc., 1973.

6. Leonard, W. P., The Management Audit, Prentice Hall, 1963.

7. Buckley, J. W., "Operational Audits by Public Accountants", in Perspectives in Auditing, ed. by Carmichael, D.R., and Willingham, J. J., McGraw-Hill Book Company, 1971.

8. Burton, J. C., "Management Auditing," The Journal of Accountancy, May 1968.

9. Cadmus, B., Operational Auditing Handbook, The Institute of Internal Auditors, Inc., 1964.

10. Sawyer, L. B., The Practice of Modern Internal Auditing, The Institute of Internal Auditors, Inc., 1973.

11. Carmichael, D. R., "Some Hard Questions on Management Audits," in Perspectives in Auditing, ed. by Carmichael, D. R. and Willingham, J. J., McGraw-Hill Book Company, 1971.

12. Robertson, J. C., Auditing, Business Publications, Inc., 1979.

13. Cases in Accountability: The Work of the GAO, Westview Press,Inc., 1979.

14. Morse, Jr., E. H., "Operational or Performance Auditing of Government Activities," The Government Accountants Journal, Vol. XXV, Number 3, Fall 1976.

15. U. S. Coast Guard Manual for Non-appropriated Fund Activities, CG-146.

16. Commandant, U. S. Coast Guard, (G-FER-1/TP51).

17. Webber, R. A., Management, Richard D. Irwin, Inc., 1979.

18. Doherty, R. P., "Shaping the Inspector General Law," The Government Accountants Journal, Vol. XXVIII, Number 1, Spring 1979.

19. Fountain, L. H., "What Congress Expects from the New Inspectors General," The Government Accountants Journal, Vol. XXVIII, Number 1, Spring 1979.

20. McBride, T. F., "The Role of Audit Under Inspector General Concept," The Government Accountants Journal, Vol. XXVIII, Number 1, Spring 1979.

21. Greenstone, S., quoted in Proceedings of Eighth Financial Management Conference, March 19, 1979.

22. Blanchard, R., Department of Transportation, (Plans and Procedures Branch of the Inspector Generals Office), on April 30, 1980.

23. Department of Transportation, Fifth Annual Report.

24. U. S. General Accounting Office Comprehensive Audit Manual, U. S. General Accounting Office, 1978.

25. Ackoff, R., A Concept of Corporate Planning, John Wiley & Sons, Inc., 1970.

26. U. S. Coast Guard Commandant Instruction 7110.8, G-FER-1/TP51, 8 January 1980.

27. Department of the Navy Audit Manual for Management, SECNAVINST 7510.7A, 28 December 1978.

INITIAL DISTRIBUTION LIST

		No. Copies
1.	Defense Technical Information Center Cameron Station Alexandria, Virginia 22314	2
2.	Library, Code 0142 Naval Postgraduate School Monterey, California 93940	2
3.	Department Chairman, Code 54Js Department of Administrative Science Naval Postgraduate School Monterey, California 93940	1
4.	LCDR R. A. Bobulinski, Code 54Bb Department of Administrative Science Naval Postgraduate School Monterey, California 93940	4
5.	LT Paul A. Dufresne 307 Mink San Antonio, Texas 78213	1
6.	Defense Logistics Studies Information Center U. S. Army Logistics Management Center Fort Lee, Virginia 23810	1
7.	U. S. Coast Guard (G-PTE-1/72) Washington, D. C. 20490	2
8.	U. S. Coast Guard (G-FER-1/TP51) Washington, D. C. 20590	1
9.	Professor Shu S. LIAO, Code 54Lc Department of Administrative Science Naval Postgraduate School Monterey, California 93940	1

Thesis
D78395 Dufresne
c.1

189479

A model for an operational audit of United States Coast Guard non-appropriated fund activities.

3 NOV 81
27 OCT 83

27280
28722

Thesis
D78395 Dufresne
c.1

189479

A model for an operational audit of United States Coast Guard non-appropriated fund activities.

thesD78395
A model for an operational audit of Unit
3 2768 001 89538 6
DUDLEY KNOX LIBRARY